SEP 8 1986

Y 4. En 2/3:99-94

SEC OVERSIGHT

COMPLETED

277

HEARINGS

BEFORE THE

SUBCOMMITTEE ON TELECOMMUNICATIONS,
CONSUMER PROTECTION, AND FINANCE

OF THE

COMMITTEE ON ENERGY AND COMMERCE
HOUSE OF REPRESENTATIVES

NINETY-NINTH CONGRESS

ON

SEC OVERSIGHT, AUTHORIZATION, AND OTHER MATTERS—H.R. 1602,
H.R. 1603, AND H.R. 1604
MARCH 21, 1985

SEC OVERSIGHT
MARCH 5, 1986

Serial No. 99-94

ORIGINAL

Printed for the use of the Committee on Energy and Commerce

U.S. GOVERNMENT PRINTING OFFICE
60-665 O WASHINGTON : 1986

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

CDD

I

COMMITTEE ON ENERGY AND COMMERCE

JOHN D. DINGELL, Michigan, *Chairman*

JAMES H. SCHEUER, New York
HENRY A. WAXMAN, California
TIMOTHY E. WIRTH, Colorado
PHILIP R. SHARP, Indiana
JAMES J. FLORIO, New Jersey
EDWARD J. MARKEY, Massachusetts
THOMAS A. LUKEN, Ohio
DOUG WALGREN, Pennsylvania
BARBARA A. MIKULSKI, Maryland
AL SWIFT, Washington
MICKEY LELAND, Texas
RICHARD C. SHELBY, Alabama
CARDISS COLLINS, Illinois
MIKE SYNAR, Oklahoma
W.J. "BILLY" TAUZIN, Louisiana
RON WYDEN, Oregon
RALPH M. HALL, Texas
DENNIS E. ECKART, Ohio
WAYNE DOWDY, Mississippi
BILL RICHARDSON, New Mexico
JIM SLATTERY, Kansas
GERRY SIKORSKI, Minnesota
JOHN BRYANT, Texas
JIM BATES, California

JAMES T. BROYHILL, North Carolina
NORMAN F. LENT, New York
EDWARD R. MADIGAN, Illinois
CARLOS J. MOORHEAD, California
MATTHEW J. RINALDO, New Jersey
WILLIAM E. DANNEMEYER, California
BOB WHITTAKER, Kansas
THOMAS J. TAUKE, Iowa
DON RITTER, Pennsylvania
DAN COATS, Indiana
THOMAS J. BLILEY, Jr., Virginia
JACK FIELDS, Texas
MICHAEL G. OXLEY, Ohio
HOWARD C. NIELSON, Utah
MICHAEL BILIRAKIS, Florida
DAN SCHAEFER, Colorado
FRED J. ECKERT, New York

Wm. Michael Kitzmiller, *Staff Director*
Thomas M. Ryan, *Chief Counsel*
Arnold I. Havens, *Minority Counsel*

Subcommittee on Telecommunications, Consumer Protection, and Finance

TIMOTHY E. WIRTH, Colorado, *Chairman*

AL SWIFT, Washington
MICKEY LELAND, Texas
CARDISS COLLINS, Illinois
JOHN BRYANT, Texas
JIM BATES, California
THOMAS A LUKEN, Ohio
MIKE SYNAR, Oklahoma
W.J. "BILLY" TAUZIN, Louisiana
WAYNE DOWDY, Mississippi
JIM SLATTERY, Kansas
JAMES H. SCHEUER, New York
HENRY A. WAXMAN, California
EDWARD J. MARKEY, Massachusetts
JOHN D. DINGELL, Michigan
(Ex Officio)

MATTHEW J. RINALDO, New Jersey
CARLOS J. MOORHEAD, California
THOMAS J. TAUKE, Iowa
DON RITTER, Pennsylvania
DAN COATS, Indiana
THOMAS J. BLILEY, Jr., Virginia
JACK FIELDS, Texas
MICHAEL G. OXLEY, Ohio
HOWARD C. NIELSON, Utah
JAMES T. BROYHILL, North Carolina
(Ex Officio)

Marc E. Lackritz, *Staff Director/Chief Counsel*
Martha Cochran, *Senior Counsel*
Helen Wiederhorn, *Fellow*
Thomas Lykos, *Associate Minority Counsel*

CONTENTS

SEC OVERSIGHT, AUTHORIZATION, AND OTHER MATTERS

Page
Hearing held on March 21, 1985 1
Text of:
  H.R. 1602 14
  H.R. 1603 16
  H.R. 1604 18
Testimony of:
  Connolly, Joseph, Chief of the Office of Tender Offers, Securities and Exchange Commission 53
  Cox, Charles C., Commissioner, Securities and Exchange Commission 53
  Goelzer, Daniel L., General Counsel, Securities and Exchange Commission 53
  Kundahl, George G., Executive Director, Securities and Exchange Commission 53
  Lynch, Gary, Director of Division of Enforcement, Securities and Exchange Commission 53
  McCoy, Catherine C., Associate Director, Division of Corporation, Securities and Exchange Commission 53
  Marinaccio, Charles L., Commissioner, Securities and Exchange Commission 53
  Peters, Aulana L., Commissioner, Securities and Exchange Commission 53
  Shad, John S.R., Chairman, Securities and Exchange Commission 53
  Treadway, James C., Commission, Securities and Exchange Commission 53

SEC OVERSIGHT

Hearing held on March 5, 1986 122
Testimony of:
  Cox, Charles C., Commissioner, Securities and Exchange Commission 217
  Griffin, Royce, president, North American Securities Administrators Association 129
  Huber, John, Director, Division of Corporate Finance, Securities and Exchange Commission 217
  Lynch, Gary, Director, Division of Enforcement, Securities and Exchange Commission 217
  Peters, Aulana L., Commissioner, Securities and Exchange Commission 217
  Phillips, Richard M., Washington, DC 161
  Schultz, John R., Deputy Associate Director, General Government Office, General Accounting Office 145
  Shad, John S.R., Chairman, Securities and Exchange Commission 217

SEC OVERSIGHT, AUTHORIZATION, AND OTHER MATTERS

THURSDAY, MARCH 21, 1985

House of Representatives,
Committee on Energy and Commerce,
Subcommittee on Telecommunications,
Consumer Protection, and Finance,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:35 a.m., in room 2322, Rayburn House Office Building, Hon. Timothy E. Wirth (chairman) presiding.

Mr. **Wirth**. The subcommittee will come to order.

I would like to not only welcome the five distinguished members of the Securities and Exchange Commission [SEC] to the hearing today, but I would like to welcome our Republican brethren to the subcommittee. And we are delighted to be joined by the thoughtful, careful, analytic, and ever eager minority, so we can now get on with the Nation's business together.

Today, we are holding a hearing on the budget authorization request for the SEC for fiscal years 1986–88. We will examine the adequacy of the Commission's funding in view of the tremendous tasks that it faces. We will examine how it sets its priorities, given the limitations on its resources, and we will hear testimony on three bills designed to protect investors and facilitate the Commission's work.

Again and again, we hear that we have the safest, fairest, most efficient capital markets in the world. We view the SEC as the protector of those markets. But events in recent years have made it clear that the agency simply cannot do the job that we want it to do. Its resources are limited. Its statutory authority is limited, and some would say its desire to regulate those markets appears to have diminished.

During recent years, the financial markets have grown in size and complexity. Trading on the exchanges and in the over-the-counter market has reached record levels, and new products and institutions spanning industry lines have proliferated, testing the Commission's surveillance and enforcement capabilities.

The volume of new securities registered with the Commission also has surpassed all prior levels, which has placed increased demands on the Commission's disclosure review. As the markets become increasingly internationalized, complex enforcement, surveillance, and disclosure issues threaten the SEC's ability to maintain the integrity of our markets. But the Commission has fewer staff than it had in 1979.

Today, we see that our financial markets are volatile and fragile. Participants in those markets have become increasingly interrelated, and the failure of a single institution can reverberate throughout the system.

Last year, when the SEC was before this subcommittee, we discussed our concerns about the changing financial markets and the SEC's ability to regulate those markets. We talked about the financial failures in recent years that have caused great pain to investors and sent shock waves through the financial system, specifically Drysdale, Washington Public Power Supply System, and Baldwin United.

We talked about the problems inherent in a system where certain segments of the market do not have adequate SEC regulation, particularly the Government securities markets and the municipal securities markets. We questioned whether after-the-fact enforcement action was adequate to pick up the pieces after one of these failures.

Some have called these failures aberrations in an otherwise healthy system. Chairman Shad, I believe that last year you called these failures a fiasco.

Within the last 2 weeks, we've seen the collapse of yet another unregulated securities dealer, ESM Government Securities, Inc., which resulted in a savings and loan panic in Ohio and millions of dollars of losses to cities and other investors throughout the Nation. The loss of confidence by depositors obviously has serious implications for our economy and clearly shows the potential for economic dislocation and injury to individual depositors in Ohio and elsewhere.

We recently learned that the SEC was told of the problems at ESM in 1977, when it received complaints from customers about excessive markups. After 4 years, during which the SEC was unable to gain access to ESM's books and records, the SEC closed its inquiry.

We are now told that the fraud at ESM was well under way during the time the SEC was prevented from gaining access to ESM's books and records.

It is not enough for the SEC to point its finger to other regulators and to say that they have the jurisdiction and the responsibility. It is not enough for the SEC to say that it can come in after the fact and prosecute fraudulent activity.

At the hearing last year and in a series of letters from Chairman Dingell and me throughout this year, we have asked the SEC to look beyond the confines of its specific jurisdiction and to work with us to determine how best to protect investors and how best to preserve the integrity of our marvelous capital-raising system. What we hear, again from the Commission, is that Government securities are not its problem, and we should wait for another regulator to come up with a solution.

In my view, the Commission can do better than this, and the current problem in Ohio shows the consequences, in part, of this failure to do better.

Mr. Rinaldo.

Mr. **Rinaldo**. Thank you very much, Mr. Chairman.

I am pleased that we have resolved the matter of subcommittee ratios by providing a more equitable distribution of people from both sides of the aisle on this subcommittee at this time.

I want to thank the chairman also for holding this hearing and Commissioner Shad and the other members of the Commission for being with us today.

It is my understanding that Commissioners Marinaccio and Treadway will be leaving the Commission shortly, and I just want to state that it is certainly a regretful occurrence—that is, the American people, in my view, were extremely fortunate in having the benefit of their tenure, and they will certainly be missed by me and by the other members of this committee as well, because they have made a fine contribution.

The SEC celebrated its 50th anniversary last year, and despite the opening statement of my good friend, the subcommittee chairman, I think it's record of excellence as one of this Government's premier agencies has continued.

At the Commission's initiative, the exchanges are installing electronic intermarket stock and option surveillance systems. This will not only assist them in their vigorous efforts at enforcing the newly enacted insider trading legislation, but will also result in reduced transaction reconciliation costs for investors.

They have also recently undertaken efforts to improve the proxy dissemination process with respect to the activities of broker dealers and added a provision which makes it easier for issuers to communicate directly with beneficial owners of stock.

The Commission has sought to further improve shareholder communications by proposing that Congress enact legislation amending section 14(b) of the Exchange Act, so that their authority on this matter would be extended to banks. Their recommendation, if adopted, would enable both individuals, as well as institutional holders, to make better and more informed decisions regarding the stock they hold in America's corporations.

The Commission's annual report to Congress shows substantial increases in productivity, including the number of enforcement actions and the number of broker dealer inspections. Last year, the SEC collected fees amounting to 129 percent of its budget, and in my view, that is certainly an extremely commendable record, and it is too bad that this record of efficiency cannot be duplicated by other Government agencies.

I again want to thank Chairman Shad and the distinguished Commissioners for being with us here and for their hard work in the past year. I look forward to your testimony, and we will have some questions for you at a later point in this hearing. Thanks again for coming.

Mr. **Wirth**. Thank you, Mr. Rinaldo.

Mr. Luken.

Mr. **Luken**. Thank you, Mr. Chairman. I certainly thank the chairman for holding this hearing today. It comes at a very opportune time for those of us from Ohio, and I personally, from Cincinnati, feel that this hearing will be of great benefit in getting some answers to some very pointed questions.

The collapse 3 weeks ago of a Government securities dealer in Florida and the repercussions of that collapse have shaken the financial world, not only in this country, but internationally. The forced shutdown of ESM has resulted in the closure of the largest State-insured savings and loan in the State of Ohio, which happens to be in Cincinnati, and this is because of Home State's dealings with ESM, the unregulated Government securities dealer. More than half a million innocent depositors in Ohio are the victims. They have been left without access to their savings. The bank holiday of 71 savings and loans results directly from ESM activities.

My constituents are worried about the possible loss of lifesavings, access to their own funds for necessities, for the necessities of life, for food, rent, and medical care. Many waited in long lines, overnight, just a week ago, and they are ready to get back into those lines if we don't solve the problem.

And that has pertinence to our hearing today, because they are demanding answers from a Government which had rushed to the aid of an improvident behemoth, Continental Illinois, but casts an indifferent glance at the little people outside the savings and loans in Ohio.

But the collapse of ESM has victimized others as well. There are a number of cities all across this country—cities, small towns, which are ESM's creditors—and they, too, have lost millions of dollars of the taxpayers' funds.

This brings us to the questions that I believe SEC must answer today, answer to the American public, as we should, too. After all, this is not the first Government securities dealer to fail.

In 1982, we witnessed the collapse of Drysdale. Since then, we have Lombard Wall, Inc., and the Lyon Capital Group. In each case, SEC's answer has been the same.

We need not ask what SEC has done about it. It has done nothing. And I find it incredible in recounting these facts that on February 28, one of the largest accounting firms, the 11th largest accounting firm in the country, Alexander Grant, gave ESM an unqualified endorsement. Four days later, ESM was found to be about $300 million in the red, and this should have been known by any kind of oversight activity.

If the SEC was powerless to act in the face of these obvious circumstances, then why isn't the SEC clamoring for empowering legislation so it could act today That is the question that we are going to be presenting to the SEC Commissioners today.

I recognize that the SEC does not have exclusive jurisdiction over the Government securities market, nor responsibility, but the more I think about it, the more I believe in the old adage that shared responsibility is no accountability. Everyone wants to pass the buck in this case, and I think that's exactly the situation we face with respect to Federal supervision of dealers in Government securities.

The SEC says to the Fed: "You have responsibility for issuance of the Government securities, so you do it." And the Fed says to the SEC: "You regulate other securities dealers. You do it."

I submit, Mr. Chairman, that is exactly why we have the problems that we have in the Government securities markets today, problems that have brought about the most extensive shutdown of financial institutions since the bank holiday that President Roosevelt directed.

The SEC and the Fed are passing the buck back and forth while savings and loans, communities, and hundreds of thousands of depositors are paying the price.

I believe the SEC has these questions to answer today, and I look forward to the testimony.

Thank you, Mr. Chairman.

Mr. WIRTH. Thank you very much, Mr. Luken.

Mr. Oxley.

Mr. OXLEY. Thank you, Mr. Chairman.

I want to welcome our witnesses, the Commissioners of the SEC, to our hearing today.

A number of recent events have made this hearing quite timely. It will be good to hear the Commission's views on those events and what changes may be needed in light of their occurrence.

The recent spate of hostile takeover activity has been a continuing concern of mine and of this subcommittee, and although that specific issue is not the subject of today's hearing, I would be interested in the Commission's suggestions as to how or if Congress can work to make the current system more fair to shareholders.

I am particularly interested today, as is my colleague from Ohio, Mr. Luken, in the collapse of ESM Government Securities which has led to the closing of more than 70 savings and loan institutions in my home State of Ohio.

Should the SEC have authority over Government securities, and what can or should be done to prevent such occurrences in the future. As many of us know, Mr. Shaw from Florida has introduced legislation that would extend the authority of the SEC over these currently unregulated securities dealers.

And the real question that many of us, I think, have is what position the SEC may take on this legislation and whether legislation might help to avoid in the future the kind of situation that has affected not only Ohio, but, indeed, perhaps the entire financial network of this country.

And if we are to look at the effects that this particular situation has had on the dollar internationally, I don't think that it's an overstatement to say that perhaps this situation that appeared to be, at least early on, a very isolated instance, may very well take on international implications.

And if, indeed, that is the case, then the issue that we're dealing with today, through your testimony and through questions from this subcommittee, take on a very important air, much more so than perhaps would have been thought of even as early as a week ago.

So I do look forward to the Commission's response to these questions and others that I plan to ask at the appropriate time. I look forward to your testimony today.

I thank the Chair.

Mr. WIRTH. Thank you, Mr. Oxley.

Mr. Bliley.

Mr. BLILEY. Thank you, Mr. Chairman.

I, too, wish to welcome Chairman Shad and the other Commissioners of the SEC who play such an integral role in preserving the integrity of our securities market. We look forward from hearing from you about the SEC's accomplishments, its ongoing enforcement efforts, and budgetary needs for the next 3 years.

The SEC's task has become more complicated due to the rapidly changing financial marketplace and the proliferation of new financial instruments such as options, mortgage-backed securities and futures on financial instruments and stock indexes.

The expansion of securities markets has strained the Commission's resources. The SEC has admirably responded to this increase in its responsibilities by doing, as Chairman Shad has stated and the statistics reflect, more with less.

The SEC has been moving in the right direction to accommodate both its increased workload and Federal budget pressures. To combat its increased workload, it has increased its use of automation and computers to analyze problem areas and focus on those areas where attention is most needed.

It has moved toward greater reliance on self-regulation by the private sector while maintaining rigorous oversight of the private sector's regulatory role. It has refocused its enforcement priorities to emphasize clear violations of the Federal securities laws and activities which directly affect a company's financial health.

For example, it has placed increasing emphasis on the prosecution of accounting fraud cases. In fact, in recent years, the Commission has also initiated a number of reforms to reduce the regulatory burden on the securities industry without sacrificing investor protection and simultaneously reducing its own paperwork.

As the Commission enters its 51st year, it enjoys the reputation as being the premier administrative agency in the Federal regulatory system. Due to the efforts of the Commission and the dedicated individuals who administer the Federal securities laws, we enjoy the safest and most efficient securities markets in the world.

We appreciate your past cooperation with the subcommittee and look forward to the testimony you will offer today.

Thank you, Mr. Chairman.

Mr. WIRTH. Thank you, Mr. Bliley.

Mr. Swift.

Mr. SWIFT. Thank you, Mr. Chairman.

I would ask unanimous consent that my opening statement be included in the record in full and I will summarize it.

Mr. WIRTH. Without objection.

Mr. SWIFT. A lot of concentration has been placed on Ohio. I have the unwanted distinction of representing a number of local communities in Washington State that were very heavily impacted by the failure of the ESM corporate group.

Two of my counties, Clallam and Jefferson, face a potential loss of 25 to 50 percent respectively of their annual budgets. Unfortunately, ESM is only the latest in the series of market mishaps and scandals. Lombard-Wall, Lyon and Drysdale are all recent examples.

Each time—this is the point I wish to make—each time we're told that these failures are merely an aberration; that buyers will now beware and that no corrections are needed in this unregulated marketplace.

In testifying before the Senate Securities Subcommittee on the Drysdale case, Deputy Assistant Secretary of the Treasury, Mark Stalnecker, stated that, and I quote, "Additional uncertainty in the marketplace always results in lower prices for securities. And the Drysdale failure could have conceivably cost more money for the Treasury in selling T-notes."

The recent civil action filed by the SEC against ESM charges them with violations of the Securities Act of 1933, in particular fraud. And that's well and good. And I'm sure that the SEC will vigorously prosecute that action.

But as securely as you lock that particular barn door now, the real question is, Wouldn't stricter enforcement have saved some of those horses from being stolen in the first place.

For example, between 1977 and 1981, the SEC undertook an investigation of ESM but ultimately dropped that suit as it became bogged down in court. With the benefit of 20-20 hindsight, something committees almost always have to operate with, it would appear the persistance in that suit could have mitigated some of the ultimate damage caused by ESM.

I sympathize with the legal difficulties that the SEC had at getting at ESM's books. You didn't have the right tools to do the job. I hope the SEC will now help us in developing the tools necessary so that these aberrations will not occur with such distressing frequency.

Thank you, Mr. Chairman.

Mr. Wirth. Thank you very much, Mr. Swift.

[Mr. Swift's prepared statement follows:]

Statement of Hon. Al Swift

Mr. Swift. Chairman Shad, I have the unwanted distinction of representing a number of local communities that were very heavily impacted by the failure of the ESM corporate group. Two of my counties, Clallam and Jefferson, face a potential loss equal to 25% and 50% respectively of their annual budgets. We all know what the ESM collapse has done to the state of Ohio, and in turn that has led to the biggest drop in the dollar in 15 years, and a $35 rise in the price of gold. Are international investors overreacting to the ESM Ohio connection? Perhaps, but the very real suffering by many, many Americans today is the direct result of the shenanigans of an unregulated, undercapitalized—and apparently unscrupulous—government securities dealership.

Unfortunately, ESM is only the latest of a series of market mishaps and scandals; Lombard-Wall, Lion, Drysdale, are all recent examples. Each time we are told that the failure is an abberration, that buyers will now beware, and that no corrections are needed in this unregulated marketplace. But what public costs do we incur when unprincipaled dealers—dramatically short on assets—take investors down with them when they fail. Drysdale, for example, was capitalized at $20 million; when trading stopped in mid-May 1982, they had $2.5 billion in long positions and $4 billion in short. In this case, two large banks (by anybody's definition, sophisticated investors) Chase Manhatten and Manufacturers Hanover took the hit to the tune of $189 million. If the banks had not been there to absorb the losses, a number of other securities firms could very likely have gone down as well.

In testifying before the Senate Securities Subcommittee on the Drysdale case, Deputy Assistant Secretary of the Treasury Mark Stalnecker stated that "additional uncertainty in the marketplace always results in lower prices for securities [and the Drysdale failure] could have conceivably cost more money for the Treasury" in selling T notes.

In the case of Drysdale we were able to dodge the bullet; with ESM we were not so lucky, as reading any newspaper will tell you. With ESM we have a company that was capitalized at around $3 million in 1976. In less than 10 years they leveraged that money into upwards of $300 million in direct losses for investors, and who knows what secondary losses for my constituents; the citizens of Ohio, the impair-ment of the Government securities market—(what city or county treasurer wants to look at repurchase agreements right now)—and the international markets as well. That's pretty impressive leveraging for 3 million dollars—unfortunately all in a negative direction.

The recent Civil Action filed by the SEC against ESM charges them with violations of the Securities Act of 1933—in particular fraud. This is well and good, and I am sure that the SEC will vigorously prosecute this action. But as securely as you lock this particular barn door now, the real question is, don't you think that stricter enforcement could have saved some of the horses from being stolen in the first place.

For example, between 1977 and 1981 the SEC undertook an investigation of ESM but ultimately dropped the suit as it became bogged down in court. With the benefit of 20-20 hindsight, it would appear that persistance in this suit could have mitigated some of the ultimate damage caused by ESM. I sympathize with the legal difficulties that the SEC had in getting to ESM's books. You didn't have the right tools to do the job. I hope that the SEC will now help us in developing the tools necessary so that these "aberrations" will not occur with such distressing frequency.

Mr. WIRTH. Mrs. Collins.

Mrs. COLLINS. Thank you, Mr. Chairman.

I, too, want to commend you on the timeliness of today's hearing which will serve to further expose the Securities and Exchange Commission's inability to adequately address failures in Government securities markets; second, to examine why the SEC wants Congress to hold off on legislation to regulate these markets; and, third, to determine if the amount of funding requested by the Commission is sufficient to properly maintain the integrity of the U.S. capital markets.

I can't help but wonder about the convenient release earlier this week of an SEC report suggesting that problems in the Government's securities market are adequately being addressed.

If they were indeed being addressed, we should not have witnessed to the collapse of the ESM. I suppose what all this activity ultimately points to is the need for this subcommittee to make sure that the Commission has the tools it needs to effectively regulate and enforce the Federal Securities Act.

As part of that process, however, the SEC has a responsibility to uphold to the fullest its existing authority to maintain the quality of disclosure to investors as well as to prevent and detect fraud in the securities markets.

Given the problems we have found before in the Government's securities market, the SEC will be hard pressed to convince me today that we should, in effect, back off and not even consider legislative actions because they are handling the situation.

If they are handling the situation then this never should have occurred. That is not much consolation, of course, to the thousands of people in Ohio whose money is now being held hostage in savings and loan institutions courtesy of the ESM collapse.

Mr. Chairman, if the SEC's mandate is to uphold the integrity of the securities market, then it must be empowered to extend a protective arm over unregulated Government securities. What happened in Ohio must not be allowed to happen again.

Thank you, Mr. Chairman.

I yield back the balance of my time.

Mr. WIRTH. Thank you very much, Mrs. Collins.

Mr. Ritter.

Mr. RITTER. I have no statement, Mr. Chairman.

Mr. WIRTH. Mr. Leland.

Mr. **Leland**. Thank you, Mr. Chairman.

I want to commend you for holding this very important and timely hearing. I also would like to welcome Chairman Shad and the other members of the Securities and Exchange Commission.

The Commission and the Congress will be facing many issues of major importance in the next few weeks and months. I'm looking forward to working with you, Mr. Chairman, my colleagues on the subcommittee, and the Commission as we seek to develop constructive solutions to difficult problems.

Mr. Chairman, there are a number of issues I hope we will have an opportunity to discuss this morning. Of particular concern to me is the apparent inability of the SEC and other governmental entities to adequately police the Government securities market.

I hope this issue will receive a full airing this morning. I also look forward to discussing whether the SEC has adequate resources to fulfill its statutory obligation to surveying and regulating the increasingly complex securities marketplace.

Mr. Chairman, there is one very serious and dangerous issue on the horizon which has not received the public scrutiny it deserves.

Published reports indicate that the New York Stock Exchange is considering a revision of its 60-year-old rule that calls for delisting companies that authorize two classes of common stock with disparate voting rights.

I believe such an action could have serious, negative consequences for the financial marketplace, particularly individual stockholders.

As I understand it, Mr. Chairman, the exchange is considering a rule change that would allow every listed company to issue a new class of stocks which would give as little as 5 percent of the equity and yet have 50 percent of the vote. In other words, the previously outstanding stock, representing 95 percent of the equity, would have less than the majority of the votes.

Mr. Chairman, this proposal raises serious questions about the viability of corporate democracy. The New York Stock Exchange has a long and well-deserved reputation for its commitment to shareholder rights. The strict standards of the exchange have contributed to the high degree of investor confidence in our markets.

I believe, Mr. Chairman, that this proposed change should be scrutinized closely by the Congress and the Commission to forestall erosion of those standards.

I should note, Mr. Chairman, that I recognize that part of the pressure for this proposed change comes from corporate managers who are fearful of some of the abuses currently taking place in the takeover area. Pressure for the change also comes from the competition for listings between the New York Stock Exchange, the American Stock Exchange, and the National Association of Securities Dealers.

As many commentators have noted, however, what we are seeing is a race to the bottom, when we should be discussing the feasibility of raising the standards of all of the markets.

Mr. Chairman, this issue deserves close scrutiny by the exchange, the Commission, and the Congress. I hope it will receive the attention it deserves in the hearing today and in subcommittee consideration of takeover practices.

Finally, Mr. Chairman, I would again like to welcome the members of the Commission. I would particularly like to welcome Commissioner Peters and Commissioner Marinaccio, both of whom are relatively new to the Commission.

Again, Mr. Chairman, thank you very much for calling this very important hearing.

Mr. **Wirth**. Thank you very much, Mr. Leland.

Mr. Dingell.

Mr. **Dingell**. Mr. Chairman, I thank you, and I commend you for the holding of this hearing, which I regard to be extremely important and held at a particularly important time.

Mr. Shad, we welcome you. And ladies and gentlemen of the Commission, we are delighted to see you here today.

Mr. Shad, I wish to express the same concern with regard to the two classes of stock with disparate voting rights which might be approved by the changes in the rules of the New York Stock Exchange, about which concern was expressed by my dear friend from Texas.

Mr. Shad, it is important that you bear in mind that the bed of Procrustes is not the model for our Government. If you will remember, he was the giant who lived by the side of the road, and he had a couch. And travelers who passed by were invited in to enjoy that couch for the night. Those who were too long had their heads and feet cut off, and those who were too short were stretched. Very few survived a night with Procrustes.

Our Government, I believe, has the purpose of serving the broad national interest and not having the public interest cut to fit the size of the suit. And so I think it is particularly the case for your agency that you should have sufficient resources and sufficient authority to carry forward the national business that is entrusted to your hands. And that is basically assuring confidence in our securities markets and our securities industry.

This country has thrived, our investment industry has been a remarkable success, and the liquidity of the American securities markets has been a wonder to the world, and one of the reasons has been investor confidence. If one wishes to look at the consequences of lack of confidence, all they have to look at is the adventures that have taken place in the last few days in Ohio in the savings and loan industry. It was not a liquidity crunch which caused the calamity up there. It was simply a crunch with regard to public confidence. And that is a matter that I would like to address a little bit later in my comments here today.

I would observe to you that when President Roosevelt signed the Rayburn-Fletcher securities law into being, he said:

> It gives me great satisfaction to sign the Rayburn-Fletcher Securities Bill, and I know I express national feeling in congratulating Congress on its passage. For this measure at last translates some elementary standards of right and wrong into law. Events have made it abundantly clear that the merchandising of securities is really traffic in the economic and social welfare of our people. Such traffic demands the utmost good faith and fair dealing on the part of those engaged in it. If the country is to flourish, capital must be invested in enterprise. But those who seek to draw upon other people's money must be wholly candid regarding the facts on which the investor's judgment is asked.
>
> To that end, this Bill requires the publicity necessary for sound investment. It is, of course, no insurance against errors of judgment. That is the function of no government. It does give assurance, however, that, within the limit of its powers, the

> Federal Government will insist upon knowledge of the facts on which alone judgment can be based.
>
> The new law will also safeguard against the abuses of high-pressure salesmanship in security flotations. It will require full disclosure of all the public interests on the part of those who seek to sell securities to the public.
>
> The Act is intended to correct some of the evils which have been so glaringly revealed in the private exploitation of the public's money. This law and its effective administration are steps in a program to restore some old-fashioned standards of rectitude. Without such an ethical foundation, economic well-being cannot be achieved.

Six statutes and various amendments have been adopted by the Congress over the years since then, but the basic purpose of that statute has never been impaired and has never been diminished. Your agency has been led by such outstanding Americans as Joseph Kennedy, James Landis, William O. Douglas, Bill Cary, Mannie Cohen, and there have been many contributions by its Commissioners and staff. And you and your Commission are not only to be commended, but you are to be cautioned and to be encouraged, because I detect that new problems are appearing on the horizon.

The recent collapse of ESM Government Securities has spawned some $350 million in losses by local governments and thrifts across the country. It has triggered a massive banking crisis in Ohio, which has had consequences for everything including confidence in the dollar in Europe and a sharp increase in the price of gold. I would observe that the dollar fell with the announcements of many of the events which attended the banking and savings and loan problem in Ohio.

I note some hostility in the administration to areas of your mandate. I remind you that you are an independent agency, responsive to Congress, and not to the Office of Management and Budget. I would observe that there are enormous levels of concern in the administration which flow contra to the concerns that the Congress has expressed over the years in the matters of broker dealer abuses, tender offer abuses, losses in unregulated markets, some examples of which are to be seen in the cases of Baldwin-United, WPPSS, ESM Government Securities, Drysdale, and a number of other matters.

And I would point out to you that one of the specific concerns of this committee and the Congress is correcting the situation we see which made possible the collapse in ESM. And I will tell you that any comment received by this committee from you or a member of the Commission this morning advocating temporizing, delay, waiting, and not doing anything on the problem of ESM and unregulated Government securities brokers and dealers will be poorly received.

I would like to read just a couple words from Mr. Galbraith's comments in "The Great Crash" which I think might be highly relevant this morning:

> As protection against financial illusion or insanity, memory is far better than the law. When the memory of the 1929 disaster failed, law and regulation no longer sufficed. In protecting people from the cupidity of others and their own, history is highly utilitarian. It sustains memory.

And memory serves the same purpose as the SEC and, on the record, is far more effective.

I would hope that we can rely on memory. I would hope still more greatly that we can rely on the SEC, not only to have the powers that are necessary, but to exercise them vigorously and to see to it that the budget which it has is sufficient.

I observe that you generate more in revenues than you spend. I commend you for that. But I would urge you not to limit yourself on some arbitrary standard of saving of money, when you might, by that event, jeopardize the entirety of our securities markets.

Thank you, Mr. Chairman.

[Mr. Dingell's prepared statement follows:]

STATEMENT OF HON. JOHN D. DINGELL

The need for reform in the conduct of the financial markets of the Nation had become fixed in the public mind in the years following the stock market crash in 1929. This public demand for reform was reflected in the Democratic Platform of 1932, which stated:

"We advocate protection of the investing public by requiring to be filed with the government, and carried in advertisements, of all offerings of foreign and domestic stocks and bonds, true information as to bonuses, commissions, principal invested, and interests of the seller."

On March 29, 1933, President Franklin Delano Roosevelt sent a message to the Congress asking for legislation to change "the ancient doctrine of caveat emptor to 'let the seller beware' " and "put the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence."

On May 27, 1933, the President signed the Rayburn-Fletcher Securities Bill into law. Memories tend to fade with the passage of time. Sometimes we lose sight of our purpose. His words therefore, I believe, bear repeating:

"It gives me much satisfaction to sign the Rayburn-Fletcher Securities Bill, and I know I express national feeling in congratulating Congress on its passage. For this measure at last translates some elementary standards of right and wrong into law. Events have made it abundantly clear that the merchandising of securities is really traffic in the economic and social welfare of our people. Such traffic demands the utmost good faith and fair dealing on the part of those engaged in it. If the country is to flourish, capital must be invested in enterprise. But those who seek to draw upon other people's money must be wholly candid regarding the facts on which the investor's judgment is asked.

"To that end this Bill requires the publicity necessary for sound investment. It is, of course, no insurance against errors of judgment. That is the function of no Government. It does give assurance, however, that, within the limit of its powers, the Federal Government will insist upon knowledge of the facts on which alone judgment can be based.

"The new law will also safeguard against the abuses of high-pressure salesmanship in security flotations. It will require full disclosure of all the private interests on the part of those who seek to sell securities to the public.

"The Act is thus intended to correct some of the evils which have been so glaringly revealed in the private exploitation of the public's money. This law and its effective administration are steps in a program to restore some old-fashioned standards of rectitude. Without such an ethical foundation, economic well-being cannot be achieved."

Six statutes, and various amendments, have been enacted since then to create an efficient and effective regulatory structure. The SEC has earned a reputation as an able administrator of America's securities market system. It has benefitted from the leadership of such chairmen as Joseph Kennedy, James Landis, William O. Douglas, Bill Cary, and Manny Cohen and the many contributions of its commissioners and staff. Ladies and gentlemen, you are to be commended for the work that you do to protect the public and preserve the integrity of our markets.

However, I must observe that I am very troubled by some of the things I see. The failure of ESM Government Securities has spawned more than $355 million in losses by local governments and thrifts across the country, has triggered Ohio's banking crisis and has spread to the international financial markets where the price of gold rose more than $35 per ounce and the dollar declined sharply. Competition between the NASD and the exchanges, between the futures and securities markets, and between foreign and U.S. markets is generating a regulatory race to the bottom. This will not do at all. The Oversight and Investigations Subcommittee has opened an inquiry into the question of listing standards and shareholder voting rights. We will be announcing hearings in the near future.

Also, I see a basic hostility in some quarters of this Administration to many areas of your mandate. The number and vehemence of complaints from the public received by my office and by the Committee in the areas of broker-dealer abuses, tender offer abuses, losses in unregulated markets represented by the likes of Baldwin-United, WPPSS, and ESM Government Securities, is way up. Yet, I am struck by the constant admonitions not to do anything, that all is well, and that free market forces will take care of everything. Free market forces won't restore investor confidence or put lost money back in the pockets of people who were fleeced in the debacles I mentioned. Free market forces, unchannelled, do not create value but rather place undue strain on the system. Water is essential to all life: human, animal and plant. Yet, unharnessed, it can destroy everything in its path. That is why we build dams. The analogy should not be lost on us.

Mr. Shad, the President's budget does not give you near enough money to do your job. As a consequence, you are deregulating and delegating to the private sector in ways that will net unpleasant consequences. By the admission of your own budget documents, many things just plain are not getting done. I hope that the Subcommittee will be responsive to these concerns.

It is highly appropriate, indeed, necessary to reassess the premises and structures of our laws. We must remain flexible and be responsive to new developments. However, everything older than 50 is not ready for the trash heap and I will vigorously oppose any efforts, either through the budget process or through so-called regulatory reform, to unravel the important protections which you are charged to administer for our citizens.

In closing, I decided that these remarks should have some "intellectual" content. Accordingly, I will leave you with these cautionary words from John Kenneth Galbraith's "The Great Crash": "As protection against financial illusion or insanity, memory is far better than law. When the memory of the 1929 disaster failed, law and regulation no longer sufficed. For protecting people from the cupidity of others and their own, history is highly utilitarian. It sustains memory and memory serves the same purpose as the SEC and, on the record, is far more effective."

Mr. WIRTH. Thank you very much, Mr. Chairman.

This morning we welcome back to the subcommittee the gentleman from Virginia, Mr. Bliley, who served us so ably from 1980 to 1982.

We also welcome for the first time the gentleman from Pennsylvania, Mr. Ritter, and look forward to his involvement on the committee.

And we also welcome our last member who has joined us this morning, the gentleman from Utah, Mr. Nielson. Again, welcome to you all and thank you very much for joining us. As you can see, Chairman Shad, we have a very deep interest in this issue and a deep concern about the issue and look forward, as we have in the past, to working with you and members of the Commission.

Before recognizing you for your statement, I would like to make note of Commissioner Treadway's departure and valued service over the last 3 years. We wish you well and look forward to working with you. I understand you are going to be staying in Washington. Thank you very much for your very valued and sensible assistance.

To Commissioner Marinaccio, the same. You will be leaving, I understand, in June, and I know that you have not only worked for the Commission, but for many years on the Senate side, and we wish you well and thank you very much for your help.

Ms. Peters, your seniority is going to look very good in June.

[Testimony resumes on p. 53.]

[The text of H.R. 1602, H.R. 1603 and H.R. 1604 follow:]

I

99TH CONGRESS
1ST SESSION

H. R. 1602

To amend the Securities Exchange Act of 1934 to authorize appropriations for the Securities and Exchange Commission for fiscal years 1986 through 1988.

IN THE HOUSE OF REPRESENTATIVES

MARCH 20, 1985

Mr. WIRTH (for himself and Mr. Rinaldo) (by request) introduced the following bill; which was referred to the Committee on Energy and Commerce

---

A BILL

To amend the Securities Exchange Act of 1934 to authorize appropriations for the Securities and Exchange Commission for fiscal years 1986 through 1988.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 35 of the Securities Exchange Act of 1934 (15 U.S.C. 78kk) is amended—

(1) by striking out the first sentence and inserting in lieu thereof "There are hereby authorized to be appropriated to carry out the functions, powers, and duties of the Commission not to exceed $113,647,000 for the fiscal year ending September 30, 1986, $116,023,000 for the fiscal year ending September 30,

1987, and $121,837,000 for the fiscal year ending September 30, 1988."; and

(2) in the last sentence thereof, by striking out "fiscal year 1983" and inserting in lieu thereof "fiscal year 1988."

○

I

99TH CONGRESS
1ST SESSION

H. R. 1603

To amend the Securities Exchange Act of 1934 to authorize the Securities and Exchange Commission to subject banks, associations, and other entities that exercise fiduciary powers, to the same regulations as broker-dealers, pursuant to section 14(b) of the Securities Exchange Act of 1934.

IN THE HOUSE OF REPRESENTATIVES

MARCH 20, 1985

Mr. WIRTH (for himself and Mr. RINALDO) (by request) introduced the following bill; which was referred to the Committee on Energy and Commerce

---

A BILL

To amend the Securities Exchange Act of 1934 to authorize the Securities and Exchange Commission to subject banks, associations, and other entities that exercise fiduciary powers, to the same regulations as broker-dealers, pursuant to section 14(b) of the Securities Exchange Act of 1934.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Shareholder Communications Act of 1985".

SEC. 2. AMENDMENT TO SECURITIES EXCHANGE ACT OF 1934.

Section 14(b) of the Securities Exchange Act of 1934 is amended by inserting "or any bank, association, or other entity that exercises fiduciary powers," after "under this title,".

SEC. 3. EFFECTIVE DATE.

The amendment made by this Act shall become effective one year after the date of enactment of this Act.

○

I

99TH CONGRESS
1ST SESSION

H. R. 1604

To amend the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, and the Investment Advisers Act of 1940 to make certain technical, clarifying, and conforming amendments, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

MARCH 20, 1985

Mr. WIRTH (for himself and Mr. RINALDO) (by request) introduced the following bill; which was referred to the Committee on Energy and Commerce

---

A BILL

To amend the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, and the Investment Advisers Act of 1940 to make certain technical, clarifying, and conforming amendments, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Securities Law Technical Amendments Act of 1985".

BEST COPY AVAILABLE

TITLE I—AMENDMENTS OF SECURITIES ACT OF 1933

SEC. 101. Section 2(5) of the Securities Act of 1933 (15 U.S.C. 77b(5)) is amended by striking out "Federal Trade Commission" and inserting in lieu thereof "Securities and Exchange Commission".

SEC. 102. Section 2(6) of the Securities Act of 1933 (15 U.S.C. 77b(6)) is amended by striking out "Canal Zone,".

SEC. 103. Paragraph (1) of section 3(a) of the Securities Act of 1933 (15 U.S.C. 77c(a)(1)) is hereby repealed.

SEC. 104. Section 3(a)(2) of the Securities Act of 1933 (15 U.S.C. 77c(a)(2)) is amended—

(1) by striking out "section 103(c)" each place it appears and inserting in lieu thereof "section 103(b)"; and

(2) by striking out "(7)" and inserting in lieu thereof "(13)".

SEC. 105. Section 3(a)(5)(A) of the Securities Act of 1933 (15 U.S.C. 77c(a)(5)(A)) is amended by striking out ", except that the foregoing exemption shall not apply with respect to any such security where the issuer takes from the total amount paid or deposited by the purchaser, by way of any fee, cash value or other device whatsoever, either upon termination of the investment at maturity or before maturity, an aggregate amount in excess of 3 per centum of the face value of such security".

SEC. 106. Section 6(e) of the Securities Act of 1933 (15 U.S.C. 77f(e)) is hereby repealed.

SEC. 107. Section 9(a) of the Securities Act of 1933 (15 U.S.C. 77i(a)) is amended—

(1) by striking out "Circuit Court of Appeals" and inserting in lieu thereof "court of appeals";

(2) by striking out "Court of Appeals of the District of Columbia, by filing in such court" and inserting in lieu thereof "United States Court of Appeals for the District of Columbia, by filing in such Court"; and

(3) by striking out "sections 239 and 240 of the Judicial Code, as amended (U.S.C., title 28, secs. 346 and 347)" and inserting in lieu thereof "section 1254 of title 28, United States Code".

SEC. 108. Section 19(c) of the Securities Act of 1933 (15 U.S.C. 77s(c)) is amended by adding at the end thereof the following new paragraph:

"(6) Notwithstanding any other provision of law, neither the Commission nor any other person shall be required to establish any procedures not specifically required by the securities laws, as that term is defined in section 3(a)(42) of the Securities Exchange Act of 1934, or by chapter 5 of title 5,

BEST COPY AVAILABLE

United States Code, in connection with cooperation, coordination, or consultation with:

"(A) any association referred to in paragraph (1) or (3) or any conference or meeting referred to in paragraph (4), while such association, conference, or meeting is carrying out activities in furtherance of the provisions of this subsection; or

"(B) any forum, agency, organization, or group referred to in section 503 of the Small Business Investment Incentive Act of 1980, while such forum, agency, organization, or group is carrying out activities in furtherance of the provisions of such section 503.

As used in this paragraph, the terms 'association', 'conference', 'meeting', 'forum', 'agency', 'organization', and 'group' include any committee, subgroup, or representative of such entities.".

Sec. 109. (a) Section 20(b) of the Securities Act of 1933 (15 U.S.C. 77t(b)) is amended by striking out the first sentence and inserting in lieu thereof the following: "Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this title, or of any rule or regulation prescribed under authority thereof, the Commission may, in its discretion, bring an action in any district court of the United States, or United

States court of any Territory, to enjoin such acts or practices, and upon a proper showing, a permanent or temporary injunction or restraining order shall be granted without bond.".

(b) Section 20(c) of such Act (15 U.S.C. 77t(c)) is amended to read as follows:

"(c) Upon application of the Commission, the district courts of the United States and the United States courts of any Territory shall have jurisdiction to issue writs of mandamus commanding any person to comply with the provisions of this title or any order of the Commission made in pursuance thereof.".

SEC. 110. Section 22(a) of the Securities Act of 1933 (15 U.S.C. 77v(a)) is amended—

(1) by striking out "United States, the" in the first sentence and inserting in lieu thereof "United States and";

(2) by striking out ", and the United States District Court for the District of Columbia"; and

(3) by striking out "sections 128 and 240 of the Judicial Code, as amended (U.S.C., title 28, secs. 225 and 347)" and inserting in lieu thereof "sections 1254, 1291, 1292, and 1294 of title 28, United States Code".

BEST COPY AVAILABLE

TITLE II—AMENDMENTS OF SECURITIES EXCHANGE ACT OF 1934

SEC. 201. Section 3(a)(6)(C) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(6)(C)) is amended by striking out "under section 11(k) of the Federal Reserve Act, as amended" and inserting in lieu thereof "under the authority of the Comptroller of the Currency pursuant to the first section of Public Law 87-722 (12 U.S.C. 92a)".

SEC. 202. Section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)) is amended by striking out "(g)(2)" and inserting in lieu thereof "(g)(3)".

SEC. 203. Section 3(a)(16) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(16)) is amended by striking out "the Canal Zone,".

SEC. 204. Section 3(a)(22)(B) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(22)(B)) is amended—

(1) by striking out "association or any" and inserting in lieu thereof "association, or any"; and

(2) by striking out "own behalf in" and inserting in lieu thereof "own behalf, in".

SEC. 205. Section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(29)) is amended—

(1) by striking out "section 103(c)" each place it appears and inserting in lieu thereof "section 103(b)"; and

(2) by striking out "(7)" and inserting in lieu thereof "(13)".

Sec. 206. Section 3(a)(34)(C) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(34)(C)) is amended by striking out "state" each place it appears and inserting in lieu thereof "State".

Sec. 207. Section 3(a)(39)(B) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(39)(B)) is amended—

(1) by striking out "months, revoking" and inserting in lieu thereof "months, or revoking"; and

(2) by striking out "barring his" and inserting in lieu thereof "barring or suspending for a period not exceeding twelve months his".

Sec. 208. Section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)) is amended by adding at the end thereof the following new paragraphs:

"(42) The term 'securities laws' means the Securities Act of 1933 (15 U.S.C. 77a et seq.), the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.), the Public Utility Holding Company Act of 1935 (15 U.S.C. 79a et seq.), the Trust Indenture Act of 1939 (15 U.S.C. 77aaa et seq.), the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.), the Investment Advisers Act of 1940 (15 U.S.C. 80b et seq.), and the

Securities Investor Protection Act of 1970 (15 U.S.C. 78aaa et seq.).

"(43) The terms 'person associated with a transfer agent' and 'associated person of a transfer agent' mean any person (except an employee whose functions are solely clerical or ministerial) directly engaged in the management, direction, supervision, or performance of any of the transfer agent's activities with respect to transfer agent functions, and any person directly or indirectly controlling such activities or controlled by the transfer agent in connection with such activities.".

Sec. 209. Section 4 of the Securities Exchange Act of 1934 (15 U.S.C. 78d) is amended by adding at the end thereof of the following new subsection:

"(c) Notwithstanding any other provision of law, whenever any fee is required to be paid to the Commission pursuant to any provision of the securities laws or any other law, the Commission may provide by rule that such fee shall be paid in a manner other than in cash.".

Sec. 210. (a) The Securities Exchange Act of 1934 is amended by inserting after section 4 (15 U.S.C. 78d) the following new sections:

"DELEGATION OF FUNCTIONS BY COMMISSION

"Sec. 4A. (a) In addition to its existing authority, the Securities and Exchange Commission shall have the authority to delegate, by published order or rule, any of its functions to a division of the Commission, an individual Commissioner, an administrative law judge, or an employee or employee board, including functions with respect to hearing, determining, ordering, certifying, reporting, or otherwise acting as to any work, business, or matter. Nothing in this section shall be deemed to supersede the provisions of section 556(b) of title 5, or to authorize the delegation of the function of rulemaking as defined in subchapter II of chapter 5 of title 5, United States Code, with reference to general rules as distinguished from rules of particular applicability, or of the making of any rule pursuant to section 19(c) of this title.

"(b) With respect to the delegation of any of its functions, as provided in subsection (a) of this section, the Commission shall retain a discretionary right to review the action of any such division of the Commission, individual Commissioner, administrative law judge, employee, or employee board, upon its own initiative or upon petition of a party to or intervenor in such action, within such time and in such manner as the Commission by rule shall prescribe. The vote of one member of the Commission shall be sufficient to bring any such action before the Commission for review. A person or party shall be entitled to review by the Commission if he or it is adversely affected by action at a delegated level which (1) denies any request for action pursuant to section 8(a) or section 8(c) of the Securities Act of 1933 or the first sentence of section 12(d) of this title; (2) suspends trading in a security pursuant to section 12(k) of this title; or (3) is pursuant to any provision of this title in a case of adjudication, as defined in section 551 of title 5, United States Code, not required by this title to be determined on the record after notice and opportunity for hearing (except to the extent there is involved a matter described in section 554(a)(1) through (6) of such title 5).

"(c) If the right to exercise such review is declined, or if no such review is sought within the time stated in the rules promulgated by the Commission, then the action of any such division of the Commission, individual Commissioner, administrative law judge, employee, or employee board, shall, for all purposes, including appeal or review thereof, be deemed the action of the Commission.

"TRANSFER OF FUNCTIONS WITH RESPECT TO ASSIGNMENT OF PERSONNEL TO CHAIRMAN

"SEC. 4B. In addition to the functions transferred by the provisions of Reorganization Plan Numbered 10 of 1950 (64 Stat. 1265), there are hereby transferred from the Commission to the Chairman of the Commission the functions of the Commission with respect to the assignment of Commission personnel, including Commissioners, to perform such functions as may have been delegated by the Commission to the Commission personnel, including Commissioners, pursuant to section 4A of this title.".

(b) The Act of August 20, 1962 (Public Law 87-592; 76 Stat. 394), is hereby repealed.

SEC. 211. The first sentence of section 6(c)(2) of the Securities Exchange Act of 1934 (15 U.S.C. 78f(c)(2)) is amended by striking out "protection shall" and inserting in lieu thereof "protection of investors shall".

SEC. 212. Section 6(c)(3)(A) of the Securities Exchange Act of 1934 (15 U.S.C. 78f(c)(3)(A)) is amended by striking out "association" and inserting in lieu thereof "associated".

SEC. 213. Section 6(c)(4) of the Securities Exchange Act of 1934 (15 U.S.C. 78f(c)(4)) is amended by striking out "may (A) limit" and inserting in lieu thereof "may limit (A)".

SEC. 214. Section 6(e) of the Securities Exchange Act of 1934 (15 U.S.C. 78f(e)) is amended—

(1) by striking out paragraph (3) thereof and by redesignating paragraph (4) as paragraph (3); and

(2) in paragraph (3)(E) (as so redesignated)—

(A) by striking out "fixes" and inserting in lieu thereof "fixing";

(B) by striking out "paragraph (4)(A)" and inserting in lieu thereof "subparagraph (A) of this paragraph"; and

BEST COPY AVAILABLE

(C) by striking out "paragraph (4)(B)" and inserting in lieu thereof "subparagraph (B) of this paragraph".

Sec. 215. Section 11A of the Securities Exchange Act of 1934 (15 U.S.C. 78k–1) is amended—

(1) by striking out "transaction" in subsection (b)(2) and inserting in lieu thereof "transactions"; and

(2) by striking out everything after the first sentence in paragraph (4) of subsection (c).

Sec. 216. Sections 11A(e) and 12(m) of the Securities Exchange Act of 1934 (15 U.S.C. 78k–1(e) and 78*l*(m)) are hereby repealed.

Sec. 217. Section 13(c) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(c)) is amended by striking out "thereof of" and inserting in lieu thereof "thereof".

Sec. 218. Section 13(h) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(h)) is hereby repealed.

Sec. 219. Section 15(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78*o*(b)) is amended—

(1) by striking out "fiduciary, or any" in clause (ii) of paragraph (4)(B) and inserting in lieu thereof "fiduciary, transfer agent, or";

(2) by striking out subparagraph (C) of paragraph (4) and inserting in lieu thereof the following:

"(C) is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an investment adviser, underwriter, broker, dealer, municipal securities dealer, transfer agent, or entity or person required to be registered under the Commodity Exchange Act, or as an affiliated person or employee of any investment company, bank, insurance company, or entity or person required to be registered under such Act, or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security.";

(3) by striking out "or seeking to become associated," in the first sentence of paragraph (6) and inserting in lieu thereof "seeking to become associated, or, at the time of the alleged misconduct, associated or seeking to become associated"; and

(4) by striking out "17A(b)(4)(B)" in paragraph (10) and inserting in lieu thereof "17A(b)(4)(A)".

SEC. 220. Section 15B(b)(2)(C) of the Securities Exchange Act of 1934 (15 U.S.C. 78*o*–4(b)(2)(C)) is amended—

(1) by striking out "security" and inserting in lieu thereof "securities";

(2) by striking out "or the securities"; and

(3) by striking out "burden or competition" and inserting in lieu thereof "burden on competition".

SEC. 221. Section 15B(c)(4) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-4(c)(4)) is amended by striking out the first sentence and inserting in lieu thereof the following: "The Commission, by order, shall censure or place limitations on the activities or functions of any person associated, seeking to become associated, or, at the time of the alleged misconduct, associated or seeking to become associated with a municipal securities dealer, or suspend for a period not exceeding twelve months or bar any such person from being associated with a municipal securities dealer, if the Commission finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or bar is in the public interest and that such person has committed any act or omission enumerated in subparagraph (A), (D), or (E) of paragraph (4) of section 15(b) of this title, has been convicted by any offense specified in subparagraph (B) of such paragraph (4) within ten years of the commencement of the proceedings under this paragraph, or is enjoined from any action, conduct, or practice specified in subparagraph (C) of such paragraph (4).".

SEC. 222. Section 15B(c)(6)(A) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-4(c)(6)(A)) is amended by striking out "board" and inserting in lieu thereof "Board".

Sec. 223. Section 17 of the Securities Exchange Act of 1934 (15 U.S.C. 17q) is amended—

(1) by striking out subsection (c)(2) and inserting in lieu thereof the following:

"(2) The appropriate regulatory agency for a clearing agency, transfer agent, or municipal securities dealer for which the Commission is not the appropriate regulatory agency shall file with the Commission notice of the commencement of any proceeding and a copy of any order entered by such appropriate regulatory agency against any clearing agency, transfer agent, municipal securities dealer, or person associated with a transfer agent or municipal securities dealer, and the Commission shall file with such appropriate regulatory agency, if any, notice of the commencement of any proceeding and a copy of any order entered by the Commission against the clearing agency, transfer agent, or municipal securities dealer, or against any person associated with a transfer agent or municipal securities dealer for which the agency is the appropriate regulatory agency."; and

(2) by striking out subsection (f)(3) and inserting in lieu thereof the following:

"(3) In order to carry out the purposes of paragraphs (1) and (2) of this subsection, the Commission or its designees may enter into agreements with the Attorney General that will permit the Commission or the designees to use the facilities of the Federal Bureau of Investigation to receive, store, and disseminate information in regard to missing, lost, counterfeit, or stolen securities and to have direct inquiry access to such information. Notwithstanding any other provision of law, in performing identification and processing functions pursuant to paragraph (2), the Attorney General shall provide the Commission, and self-regulatory organizations that the Commission designates, with access to all criminal history record information in the possession of the Federal Bureau of Investigation, including any such information in the Computerized Criminal History File.".

SEC. 224. Section 17A of the Securities Exchange Act of 1934 (15 U.S.C. 78q-1) is amended—

(1) by inserting "and any persons associated with the transfer agent" after "concerning such transfer agent" in subsection (c)(2);

(2) by striking out "thirty" in such subsection (c)(2) and inserting in lieu thereof "forty-five";

(3) by striking out subsection (c)(3)(A) and inserting in lieu thereof the following:

"(3) The appropriate regulatory agency for a transfer agent, by order, shall deny registration to, censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of such transfer agent, if such appropriate regulatory agency finds, on the record after notice and opportunity for hearing, that such denial, censure, placing of limitations, suspension, or revocation is in the public interest and that such transfer agent, whether prior or subsequent to becoming such, or any person associated with such transfer agent, whether prior or subsequent to becoming so associated—

"(A) has committed or omitted any act enumerated in subparagraph (A), (D), (E) of paragraph (4) of section 15(b) of this title, has been convicted of any offense specified in subparagraph (B) of such paragraph (4) within ten years of the commencement of the proceedings under this paragraph, or is enjoined from any action, conduct, or practice specified in subparagraph (C) of such paragraph (4); or

"(B) is subject to an order entered pursuant to subparagraph (C) of paragraph (4) of this subsection barring or suspending the right of such person to be associated with a transfer agent.";

(4) by redesignating paragraphs (3)(B) and (3)(C) of subsection (c) as paragraphs (4)(A) and (4)(B), respectively, of such subsection;

(5) by inserting after subsection (c)(4)(B) (as so redesignated) the following new subparagraph:

BEST COPY AVAILABLE

"(C) The appropriate regulatory agency for a transfer agent, by order, shall censure or place limitations on the activities or functions of any person associated, seeking to become associated, or, at the time of the alleged misconduct, associated or seeking to become associated with the transfer agent, or suspend for a period not exceeding twelve months or bar any such person from being associated with the transfer agent, if the appropriate regulatory agency finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or bar is in the public interest and that such person has committed or omitted any act enumerated in subparagraph (A), (D), or (E) of paragraph (4) of section 15(b) of this title, has been convicted of any offense specified in subparagraph (B) of such paragraph (4) within ten years of the commencement of the proceedings under this paragraph, or is enjoined from any action, conduct, or practice specified in subparagraph (C) of such paragraph (4). It shall be unlawful for any person as to whom such an order suspending or barring him from being associated with a transfer agent is in effect willfully to become, or to be, associated with a transfer agent without the consent of the appropriate regulatory agency that entered the order and the appropriate regulatory agency for that transfer agent. It shall be unlawful for any transfer agent to permit such a person to become, or remain, a person associated with it without the consent of such appropriate regulatory agencies, if the transfer agent knew, or in the exercise of reasonable care should have known, of such order. The Commission may establish, by rule, procedures by which a transfer agent reasonably can determine whether a person associated or seeking to become associated with it is subject to any such order, and may require, by rule, that any transfer agent comply with such procedures.";

(6) by striking out "clearing agency or transfer agent" in subsection (d)(3)(B) and inserting in lieu thereof "clearing agency, transfer agent, or person associated with a transfer agent"; and

(7) by inserting ", or a person associated with a transfer agent," after "transfer agent" in subsection (d)(4).

SEC. 225. Section 21 of the Securities Exchange Act of 1934 (15 U.S.C. 78u) is amended—

(1) by striking out "Wherever" and inserting in lieu thereof "Whenever".

(2) by striking out ", and the United States District Court for the District of Columbia," in subsection (e); and

(3) by striking out the second sentence of subsection (g).

SEC. 226. Section 23(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78w(a)) is amended—

(1) by inserting "or" before "any self-regulatory organization" in the last sentence of paragraph (1); and

(2) by inserting "shall" after "section 19(b) of this title," in paragraph (3).

SEC. 227. Section 23(b)(4)(F) of the Securities Exchange Act of 1934 (15 U.S.C. 78w(b)(4)(F)) is amended by striking out "The" and inserting in lieu thereof "the".

SEC. 228. Section 27 of the Securities Exchange Act of 1934 (15 U.S.C. 78aa) is amended—

(1) by striking out ", the United States District Court for the District of Columbia,"; and

(2) by striking out "sections 128 and 240 of the Judicial Code, as amended (U.S.C., title 28, secs. 225 and 347)" and inserting in lieu thereof "sections 1254, 1291, 1292, and 1294 of title 28, United States Code".

SEC. 229. Section 28(c) of the Securities Exchange Act of 1934 (15 U.S.C. 78bb(c)) is amended by striking out "self-regulatory organization or a member thereof" and inserting in lieu thereof "self-regulatory organization on a member thereof".

SEC. 230. Section 28(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78bb(d)) is amended by striking out "change is beneficial" and inserting in lieu thereof "change in beneficial".

Sec. 231. Section 28(e)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78bb(e)(1)) is amended by striking out "Amendments in 1975" and inserting in lieu thereof "Amendments of 1975".

Sec. 232. Section 211 of the Securities Exchange Act of 1934 (15 U.S.C. 78jj) is hereby repealed.

TITLE III—AMENDMENTS OF PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

Sec. 301. Section 8 of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79h) is amended by striking out "otherwise,—" and inserting in lieu thereof "otherwise—".

Sec. 302. Section 18 of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79r) is amended—

(1) by redesignating subsections (f) and (g) as subsections (e) and (f), respectively; and

(2) in subsection (f) (as so redesignated), by striking out ", the district court of the United States for the District of Columbia,".

Sec. 303. Section 24 of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79x) is amended by striking out "sections 239 and 240 of the Judicial Code, as amended (U.S.C., title 28, secs. 346 and 347)" and inserting in lieu thereof "section 1254 of title 28, United States Code".

SEC. 304. Section 25 of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79y) is amended—

(1) by striking out ", the district court of the United States for the District of Columbia,"; and

(2) by striking out "sections 128 and 240 of the Judicial Code, as amended (U.S.C., title 28, secs. 225 and 347), and section 7, as amended of the Act entitled 'An Act to establish a court of appeals for the District of Columbia', approved February 9, 1893 (D.C. Code, title 18, sec. 26)" and inserting in lieu thereof "sections 1254, 1291, 1292, and 1294 of title 28, United States Code".

SEC. 305. Section 30 of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79z-4) is amended by striking out the last sentence thereof.

TITLE IV—AMENDMENTS OF TRUST INDENTURE ACT OF 1939

SEC. 401. Section 303(4) of the Trust Indenture Act of 1939 (15 U.S.C. 77ccc(4)) is amended by striking out "undertakng" and inserting in lieu thereof "undertaking".

SEC. 402. Section 303(12) of the Trust Indenture Act of 1939 (15 U.S.C. 77ccc(12)) is amended by inserting "(including a guarantor)" after "person" each place it appears.

TITLE V—AMENDMENTS OF INVESTMENT COMPANY ACT OF 1940

Sec. 501. Section 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(19)) is amended by inserting "completed" before "fiscal years" each place it appears.

Sec. 502. Section 2(a)(39) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(39)) is amended by striking out "the Canal Zone,".

Sec. 503. Section 2(a)(48)(B) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(48)(B)) is amended by striking out "sections 55(a) (1) through (3)" and inserting in lieu thereof "paragraphs (1) through (3) of section 55(a)".

Sec. 504. Section 3(c)(3) of the Investment Company Act of 1940 (15 U.S.C. 80a–3(c)(3)) is amended—

(1) by inserting "or" after "therefor;"; and

(2) by inserting a period after "guardian" and striking out all that follows through "principal to another or others.".

Sec. 505. Paragraph (7) of section 3(c) of the Investment Company Act of 1940 (15 U.S.C. 80a–3(c)) is hereby repealed.

Sec. 506. Section 3(c)(11) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(c)(11)) is amended—

(1) by striking out "or which holds only assets of governmental plans" and inserting in lieu thereof "; or any governmental plan"; and

(2) by striking out "trusts;" and inserting in lieu thereof "trusts or governmental plans, or both;".

SEC. 507. Section 5(a)(2) of the Investment Company Act of 1940 (15 U.S.C. 80a–5(a)(2)) is amended by striking out "Close-end" and inserting in lieu thereof "Closed-end".

SEC. 508. Section 6(a) of the Investment Company Act of 1940 (15 U.S.C. 80a–6(a)) is amended—

(1) by striking out "the Canal Zone," in paragraph (1); and

(2) by striking out paragraph (2) and by redesignating paragraphs (3), (4), and (5) as paragraphs (2), (3), and (4), respectively.

SEC. 509. Section 9 of the Investment Company Act of 1940 (15 U.S.C. 80a-9) is amended—

(1) by striking out paragraphs (1) and (2) of subsection (a) and inserting in lieu thereof the following:

"(1) any person who within ten years has been convicted of any felony or misdemeanor involving the purchase or sale of any security or arising out of such person's conduct as an underwriter, broker, dealer, investment adviser, municipal securities dealer, transfer agent, or entity or person required to be registered under the Commodity Exchange Act, or as an affiliated person, salesman, or employee of any investment company, bank, insurance company, or entity or person required to be registered under the Commodity Exchange Act;

"(2) any person who, by reason of any misconduct, is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an underwriter, broker, dealer, investment adviser, municipal securities dealer, transfer agent, or entity or person required to be registered under the Commodity Exchange Act, or as an affiliated person, salesman, or employee of any investment company, bank, insurance company, or entity or person required to be registered under the Commodity Exchange Act, or from engaging in or continuing any conduct or practice in connection with any such activity or in connection with the purchase or sale of any security; or";

(2) by inserting "or of the Commodity Exchange Act," after "this title," in subsection (b)(2); and

(3) by inserting "or of the Commodity Exchange Act," after "this title," in subsection (b)(3).

SEC. 510. Section 12 of the Investment Company Act of 1940 (15 U.S.C. 80a-12) is amended—

(1) by striking out "Treasury" in subsection (d)(1)(A)(iii) and inserting in lieu thereof "treasury";

(2) by striking out "it reasonably possible" in subsection (d)(1)(G) and inserting in lieu thereof "is reasonably possible"; and

(3) by striking out "only thereof" in subsection (f) and inserting in lieu thereof "thereof only".

SEC. 511. Section 15 of the Investment Company Act of 1940 (15 U.S.C. 80a–15) is amended—

(1) by striking out "(40)" in subsection (d) and inserting in lieu thereof "(42)"; and

(2) by striking out the period at the end of subsection (f)(3)(B) and inserting in lieu thereof a comma.

SEC. 512. Section 17 of the Investment Company Act of 1940 (15 U.S.C. 80a–17) is amended by striking out the second sentence of each of subsections (h) and (i).

SEC. 513. Section 18(e) of the Investment Company Act of 1940 (15 U.S.C. 80a–18(e)) is amended by striking out paragraph (1) and by redesignating paragraphs (2) and (3) as paragraphs (1) and (2), respectively.

SEC. 514. Section 20 of the Investment Company Act of 1940 (15 U.S.C. 80a–20) is amended—

(1) by striking out the second sentence of subsection (b);

(2) by striking out the first sentence of subsection (d); and

(3) by striking out "at any time after the effective date of this title" in subsection (d).

SEC. 515. Section 21(b) of the Investment Company Act of 1940 (15 U.S.C. 80a–21(b)) is amended by striking out "to the extension or renewal of any such loan made prior to March 15, 1940, or".

SEC. 516. Section 22 of the Investment Company Act of 1940 (15 U.S.C. 80a–22(e)) is amended—

(1) by striking out "subsection (b)(8)" in paragraph (1) of subsection (b) and inserting in lieu thereof "subsection (b)(6)";

(2) by striking out paragraph (2) of subsection (b) and redesignating paragraphs (3) and (4) as paragraphs (2) and (3), respectively;

(3) by striking out "section 15A(k)(2)" in subsection (b)(2) (as so redesignated) and inserting in lieu thereof "section 19(c)";

(4) by inserting in the first sentence of subsection (e) a comma after the word "redemption" where it first appears and where it appears for the third time; and

(5) by striking out the last sentence of subsection (e).

SEC. 517. Section 24(d) of the Investment Company Act of 1940 (15 U.S.C. 80a–24(d)) is amended by inserting a period immediately after "issuer" in the second sentence thereof and by striking out all that follows in such sentence.

SEC. 518. Section 26(b) of the Investment Company Act of 1940 (15 U.S.C. 80a–26(b)) is amended by striking out "intend" and inserting in lieu thereof "intended".

SEC. 519. Section 26(c) of the Investment Company Act of 1940 (15 U.S.C. 80a–26(c)) is amended by striking out "contract of agreement" and inserting in lieu thereof "contract or agreement".

SEC. 520. Section 28(a)(2)(B) of the Investment Company Act of 1940 (15 U.S.C. 80a–28(a)(2)(B)) is amended by striking out "subsection" and inserting in lieu thereof "paragraph".

SEC. 521. Section 28(d)(2) of the Investment Company Act of 1940 (15 U.S.C. 80a–28(d)(2)) is amended by inserting "of" immediately before "subsection (a)".

SEC. 522. Section 36 of the Investment Company Act of 1940 (15 U.S.C. 80a–35) is amended—

(1) by striking out "loans" in paragraph (4) of subsection (b) and inserting in lieu thereof "loads";

(2) by redesignating subsection (d) as subsection (c), and

(3) in subsection (c) (as so redesignated), by striking out "through (e)" and inserting in lieu thereof "and (b)".

SEC. 523. Section 42 of the Investment Company Act of 1940 (15 U.S.C. 80a-41) is amended by redesignating subsection (e) as subsection (d).

SEC. 524. Section 53 of the Investment Company Act of 1940 (15 U.S.C. 80a-52) is amended by inserting a period in the first sentence thereof immediately after "1941" and by striking out everything that follows in such sentence.

SEC. 525. Section 54(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-53(a)) is amended by striking out "defined in sections" and inserting in lieu thereof "defined in section".

SEC. 526. Section 55(a)(1)(B) of the Investment Company Act of 1940 (15 U.S.C. 80a-54(a)(1)(B)) is amended by striking out "described in sections" and inserting in lieu thereof "described in section".

SEC. 527. Section 57(i) of the Investment Company Act of 1940 (15 U.S.C. 80a-56(i)) is amended by striking out "sections 17 (a) and (d)" each place it appears and inserting in lieu thereof "subsections (a) and (d) of section 17".

BEST COPY AVAILABLE

TITLE VI—AMENDMENTS OF INVESTMENT ADVISERS ACT OF 1940

SEC. 601. Section 202(a)(19) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–2(a)(19)) is amended by striking out "the Canal Zone,".

SEC. 602. Section 203 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3) is amended—

(1) by striking out "or fiduciary" in subsection (e)(2)(B) and inserting in lieu thereof "fiduciary, transfer agent, or entity or person required to be registered under the Commodity Exchange Act";

(2) by striking out paragraph (3) of subsection (e) and inserting in lieu thereof the following:

"(3) is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an investment adviser, underwriter, broker, dealer, municipal securities dealer, transfer agent, or entity or person required to be registered under the Commodity Exchange Act, or as an affiliated person or employee of any investment company, bank, insurance company, or entity or person required to be registered under the Commodity Exchange Act, or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security.";

(3) by inserting "the Commodity Exchange Act," after "this title," in subsection (e)(4);

(4) by striking out "or seeking to become associated" in the first sentence of subsection (f) and inserting in lieu thereof ", seeking to become associated, or, at the time of the alleged misconduct, associated or seeking to become associated"; and

(5) by striking out "subsection (d)" in subsection (g) and inserting in lieu thereof "subsection (c) or subsection (e)".

SEC. 603. Section 205 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-5) is amended to read as follows:

"INVESTMENT ADVISORY CONTRACTS

"SEC. 205. (a) No investment adviser, unless exempt from registration pursuant to section 203(b), shall make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, to enter into, extend, or renew any investment advisory contract, or in any way to perform any investment advisory contract entered into, extended, or renewed on or after the effective date of this title, if such contract—

"(1) provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client;

BEST COPY AVAILABLE

"(2) fails to provide, in substance, that no assignment of such contract shall be made by the investment adviser without the consent of the other party to the contract; or

"(3) fails to provide, in substance, that the investment adviser, if a partnership, will notify the other party to the contract of any change in the membership of such partnership within a reasonable time after such change.

"(b) Paragraph (1) of subsection (a) shall not—

"(1) be construed to prohibit an investment advisory contract which provides for compensation based upon the total value of a fund averaged over a definite period, or as of definite dates, or taken as of a definite date;

"(2) apply to an investment advisory contract with—

"(A) an investment company registered under title I of this Act, or

"(B) any other person (except a trust, governmental plan, collective trust fund, or separate account referred to in section 3(c)(11) of title I of this Act), provided that the contract relates to the investment of assets in excess of $1,000,000, if the contract provides for compensation based on the asset value of the company or fund under management averaged over a specified period and increasing and decreasing proportionately with the investment performance of the company or fund over a specified period in relation to the investment record of an appropriate index of securities prices or such other measure of investment performance as the Commission by rule, regulation, or order may specify; or

"(3) apply with respect to any investment advisory contract between an investment adviser and a business development company, as defined in this title, if—

"(A) the compensation provided for in such contract does not exceed 20 per centum of the realized capital gains upon the funds of the business development company over a specified period or as of definite dates, computed net of all realized capital losses and unrealized capital depreciation, and the condition of section 61(a)(3)(B)(iii) of title I of this Act is satisfied, and

"(B) the business development company does not have outstanding any option, warrant, or right issued pursuant to section 61(a)(3)(B) of title I of this Act and does not have a profit-sharing plan described in section 57(n) of title I of this Act.

"(c) For purposes of paragraph (2) of subsection (b), the point from which increases and decreases in compensation are measured shall be the fee which is paid or earned when the investment performance of such company or fund is equivalent to that of the index or other measure of performance, and an index of securities prices shall be deemed appropriate unless the Commission by order shall determine otherwise.

"(d) As used in paragraphs (2) and (3) of subsection (a), 'investment advisory contract' means any contract or agreement whereby a person agrees to act as investment adviser to or to manage any investment or trading account of another person other than an investment company registered under title I of this Act.".

SEC. 604. Section 209 of the Investment Advisers Act of 1940 (15 U.S.C. 80b–9) is amended by redesignating subsection (e) as subsection (d).

SEC. 605. Section 211(b) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–11(b)) is amended by striking out "the Federal Register Act" and inserting in lieu thereof "chapter 15 of title 44, United States Code,".

SEC. 606. Section 213(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–13(a)) is amended by striking out "sections 239 and 240 of the Judicial Code, as amended" and inserting in lieu thereof "section 1254 of title 28, United States Code".

SEC. 607. Section 214 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-14) is amended by striking out "sections 128 and 240 of the Judicial Code, as amended, and section 7, as amended, of the Act entitled 'An Act to establish a court of appeals for the District of Columbia', approved February 9, 1893" and inserting in lieu thereof "sections 1254, 1291, 1292, and 1294 of title 28, United States Code".

○

Mr. **Wirth**. Mr. Chairman, again welcome, and we look forward to your opening statement.

STATEMENT OF JOHN S.R. SHAD, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, ACCOMPANIED BY COMMISSIONER JAMES C. TREADWAY; COMMISSIONER CHARLES C. COX; COMMISSIONER CHARLES L. MARINACCIO; COMMISSIONER AULANA L. PETERS; AND DANIEL L. GOELZER, GENERAL COUNSEL; GARY LYNCH, DIRECTOR OF DIVISION OF ENFORCEMENT; GEORGE G. KUNDAHL, EXECUTIVE DIRECTOR; CATHERINE C. McCOY, ASSOCIATE DIRECTOR, DIVISION OF CORPORATION; AND JOSEPH CONNOLLY, CHIEF OF THE OFFICE OF TENDER OFFERS

Mr. **Shad**. Chairmen Dingell and Wirth and members of the subcommittee, the SEC appreciates this opportunity to provide an overview of its activities, and I would also add, appreciates the considered remarks of the members of the subcommittee and the two chairmen that are present today.

With me, on my left are the other Commissioners, James C. Treadway, Jr.; Charles C. Cox; Charles L. Marinaccio; and Aulana L. Peters. And on my right are George G. Kundahl, the SEC's Executive Director, and Daniel L. Goelzer, the SEC's general counsel. And we have also with us other senior members of the staff, and I would like to call on them, if necessary, for specific amplification of some of your questions.

The full Commission certainly notes, as you have, the outstanding contribution that James Treadway and Lindy Marinaccio have made to our deliberations over the period of their association, and they will be missed and certainly difficult to replace in terms of their contribution to the public, investors as well as the Securities and Exchange Commission's efforts.

It is requested that the Commission's written statement and 1986–88 budget request previously submitted to the subcommittee be included in the record.

Mr. **Wirth**. Without objection, it will be included in full, Mr. Chairman.

Mr. **Shad**. The Commission is here today to request authorization for fiscal 1986, 1987, and 1988 appropriations of $113.6 million, $116 million, and $121.8 million respectively, in order to implement prospective legislation, cover rising costs, and upgrade the Commission's mainframe computer.

Such legislation includes proposed amendments to the Glass-Steagall Act that would permit banks to underwrite municipal bonds and mortgage-backed securities and to sponsor and distribute mutual funds through separate corporate affiliates regulated by the SEC, and recommendations by the Bush Task Group on the Regulation of Financial Services, which would consolidate within the SEC the administration and enforcement of the securities laws with respect to publicly owned banks and thrifts.

Based on Federal pay increases projected by OMB, personnel expenses for the Commission's current staff will rise appreciably, and nonpersonnel expenses will rise due to inflation and the need to upgrade the Commission's mainframe computer.

Ensuring investor protections and maintaining clear and orderly markets require long-range planning and multiyear commitments. Such efforts include the SEC's electronic disclosure system, known as Edgar, and other productivity improvement programs which are in progress.

A 3-year authorization is needed to define the fiscal parameters within which the Commission can complete these projects and discharge its ongoing responsibilities.

The following are highlights of the Commission's Fiscal 1984 results and ongoing efforts:

Investor protection and corporations' financial flexibility were increased, and unnecessary paperwork and other expenses ultimately borne by taxpayers and investors were reduced. Through automation, paperwork reduction and other staff initiatives, record results, or the highest levels in years, were achieved in the volume and efficacy of enforcement actions, investment company and adviser inspections, broker-dealer examinations and reports processed, self-regulatory organization inspections, full disclosure filings processed, and appellate and other cases opened.

Since fiscal 1981, the annual volume of these and other Commission activities have been increased by 19 to 78 percent with 5 percent less personnel. I would particularly like to direct the subcommittee's attention to page 2 of our formal statement, which sets forth the specific details on various activities—for instance, the enforcement actions brought in fiscal 1984—57 percent, at an annual rate, more cases than in 1981. In fact, the trend has been consistently upward in all of these activities, which reflects the outstanding job done by the staff in terms of automation, paperwork reduction, and other improvements, which has enabled the Commission to, as somebody said earlier, do more with less. And this is not unique to this past 4 years.

The Commission's long-term trends have shown a consistent long-term growth in the productivity of the personnel, and I think it reflects the fact that the SEC does have, I believe, the most outstanding professionals in Government, doing a truly remarkable job, and also a Commission that is dedicated to achieving these kinds of results.

To come to specific areas of results during the past fiscal year, the pilot high-speed electronic disclosure system, known as Edgar, was commenced on schedule in September. Over 500 electronic filings have been made with the Commission by 150 companies. They range from Exxon, General Motors, IBM, and other major industrial, utility, and financial corporations to small limited partnerships, and they cover a complete cross-section of types of businesses and industries.

GMAC, the financing subsidiary of General Motors, has been one of the most frequent filers on the Edgar system, and they have indicated that Edgar has permitted them to get to the market faster, and the timing differentials here can amount to large amounts of money.

Edgar is intended to accelerate dramatically the filing, processing, dissemination, and analysis of corporate information, revolutionize the manner in which many investment decisions are made and executed, and contribute to the fairness and the efficiency of the Nation's securities markets.

As corporate reports are electronically filed with the SEC, it is intended to make them instantly available to investors, securities analysts, and others on home and business computer screens. The program is intended to correlate with the rapid growth of home computers from 16 million today to over twice that many within less than 5 years.

In addition to the analysts and others, the Edgar system will also make filings instantly available to the self-regulatory organizations, the exchanges, the NASD, and the State securities commissions, three of which are already participating in the Edgar project.

In the enforcement area, the SEC brought a record—I say "record" for many years—299 enforcement actions in fiscal 1984; 28 percent involved actions against broker-dealers, investment advisers, and other regulated entities; 16 percent were securities registration cases; 12 percent, issuer fraud and reporting cases; 11 percent, financial disclosure cases—that adds up to 33 financial disclosure cases. Also there were 18 cases against accounting firms, their partners and employees. The financial disclosure and accounting cases totaled 47, because 4 of the financial accounting cases also involved accountants. Last year, out of the 10,000 publicly owned companies, there were only—and I say "only"—it's still too many—but certainly less than 30 alleged audit failures—not proven, but alleged—and so you can see that the SEC's enforcement efforts in this area actually exceed the number of alleged audit failures.

Someone raised the question whether we were neglecting financial disclosure cases in favor of insider trading cases. We have brought a record number of insider trading cases, but they are only 4 percent, or 13 cases last year, as compared to the 51 I just alluded to in the financial disclosure area; 4 percent also were in market manipulation, and 4 percent of the cases arose out of the changes in corporate control situations.

The Commission proposed the Insider Trading Sanctions Act, which was introduced by Chairman Dingell and Chairman Wirth, and signed by the President in August 1984. Most inside traders have only been required to disgorge their profits, which has not been much of a deterrent. Now they are subject to fines up to three times their profits.

Criminal fines for violations of the securities laws were also increased from the $10,000 established 50 years ago to $100,000 per count, and we believe that these increased fines should be a significant deterrent. They have materially modified the risk reward ratio on this illegal activity.

The revised shelf registration rule has increased the largest and most creditworthy corporations' financial flexibility and has reduced their expenses for the benefit of their shareholders by hundreds of millions of dollars per annum without compromising full disclosures. These large savings are principally due to keener competition among underwriters and among the institutions which purchase the bulk of these issues when they are under shelf or conventional offerings.

The Commission is continuing to monitor the effects of the rule and will take appropriate action, if it's warranted, and those kinds of concerns particularly arise in a bear market. We haven't had one since the rule was put on the books.

Simplification and improvement of the proxy statements and prospectuses during the past year has reduced their cost and increased their utility to investors.

As a result of congressional action, implementation of the SEC Commodity Futures Trading Commission Accord has permitted us, and the CFTC to authorize new options and futures which permit investors and corporations to hedge stock market, foreign currency, and other risks at much lower cost than prior means of hedging or reducing such risks.

At the Commission's initiative, the exchanges are installing electronic intermarket stock and options surveillance systems and transaction audit trails for the quick detection of inside traders and market manipulators. Audit trails also reduce transaction reconciliation costs. At the end of an active day, as much as 5 percent of the transactions are difficult to reconcile, and those costs are ultimately borne by investors. So the audit trail serves a dual purpose of both surveillance and the markets and reducing the effective costs of reconciling transactions.

Registration, transfer and other fees, as has been mentioned, exceeded the Commission's fiscal 1984 appropriation by 29 percent.

Rules adopted by the Commission will telescope the time and expenses of corporations' communications with their own shareholders by requiring broker-dealers, commencing on January 1, 1986, to provide issuers with the identity of those shareholders who do not object.

Proposed legislation would also permit the Commission to adopt similar rules for the banks. The Commission hopes the Congress will act on this legislation during the current session.

The recommendations of Vice President Bush's Task Group on Regulation of Financial Services include consolidation within the SEC of the Securities Act filings of all publicly owned banks and thrifts, as well as other major legislative initiatives for the benefit of investors and depositors. The Commission supports the task group's recommendations.

This January, the Commission recommended that the Investment Company Act be amended to make it easier for the Commission to permit foreign investment companies to register and sell shares in the United States, when the Commission finds this to be consistent with the purposes of the act and the protection of investors. The Commission recommends that Congress consider this proposal.

The Securities Investor Protection Corporation, known as SIPC, has proposed legislation, which Chairman Dingell has introduced, to amend the Securities Investor Protection Act of 1970 in order to preserve the jurisdiction of bankruptcy judges over SIPC liquidations of insolvent broker-dealers and to make other changes in SIPC liquidation procedures. The Commission supports these objectives.

In 1983, at the request of Chairman Wirth, the Commission proposed the Securities Law Technical Amendments Act, which Chairman Wirth introduced as H.R. 4574. The bill would have made various technical changes and conforming amendments to the Federal securities laws. The Commission requests that Congress consider a similar Technical Amendments Act during this session.

Fiscal 1984 was the 50th anniversary of the SEC. The year's record results are a tribute to the Commissioners and the fine men and women who serve throughout the agency. In addition to ongoing programs, the future offers the prospect of major improvements in the regulatory structure of the financial service industries and the exciting potential of high-speed electronic filing processing, dissemination, and analysis of corporate information.

Many of the members of the committee have raised the question of ESM, which is a major area of very serious concern to this Commission, and I'll be glad to amplify on the ESM situation now or wait for your individual questions.

Thank you very much, Mr. Chairman.

[Testimony resumes on p. 74.]

[The prepared statement of the Mr. Shad follows:]

STATEMENT OF JOHN S.R. SHAD, CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION, TO THE SUBCOMMITTEE ON TELECOMMUNICATIONS, CONSUMER PROTECTION, AND FINANCE OF THE HOUSE COMMITTEE ON ENERGY AND COMMERCE

March 21, 1985

Chairman Wirth and Members of the Subcommittee:

The Securities and Exchange Commission appreciates this opportunity to present an overview of its fiscal 1984 activities and ongoing efforts. A separate statement setting forth the Commission's authorization request for 1986-88 has also been submitted. It is requested that these statements be made part of the record.

The Commission requests a three-year authorization for appropriations in the amounts of $113.6 million for fiscal 1986, $116.0 million for fiscal 1987, and $121.8 million for fiscal 1988.

The Commision's Fiftieth Annual Report, transmitted to Congress in January, provides an extensive explanation of the Commission's activities in fiscal 1984. The following briefly highlights the Commission's 1984 results and its ongoing efforts.

I. OVERVIEW OF FISCAL 1984 RESULTS AND ONGOING EFFORTS

Investor protections and corporations' financing flexibility were increased, and unnecessary paperwork and other expenses, ultimately borne by investors, were reduced.

Through automation, paperwork reduction and other staff initiatives, record results (or the highest levels in years) were achieved in the volume and efficacy of enforcement actions, investment company and adviser inspections, broker-dealer oversight examinations and reports processed, self-regulatory organization inspections, full disclosure filings processed, and appellate and other cases opened. Since fiscal 1981, the annual volume of these activities has been increased by 19% to 78%, with 5% less personnel. Also, the 1981-84 average annual rate of accounting firm peer reviews, under SEC oversight, has been increased more than 100% over the 1978-80 rate.

Summary of Activities
Securities and Exchange Commission:

SEC Fiscal Years Ended Sept. 30th	1981	1982	1983	1984	1981-4 Change
Investment Co. & Adviser Inspections	748	1,065	1,085	1,335*	+78%
SRO** Inspections	12	19	18	20*	+67%
Appellate and Other Cases	102	115	143	167*	+64%
Enforcement Actions Brought	191	254	261	299*	+57%
Broker-Dealer Oversight Examinations	278	249	324	389*	+40%
Broker-Dealer Reports Processed	6,106	6,599	7,067	8,290*	+36%
Full Disclosure Filings Processed	56,919	63,423	65,550	67,466*	+19%
Staff-Years	1,982	1,881	1,921	1,885	- 5%
Fees as a Percent of Budget	81%	94%	110%	129%*	

* A record or the highest level in years.
** Self-Regulatory Organization.

A. Edgar

The pilot high-speed electronic disclosure system ("Edgar") was commenced on schedule. It is intended to accelerate dramatically the filing, processing, dissemination and analysis of corporate information; revolutionize the manner in which many investment decisions are made and executed; and contribute to the efficiency of the securities markets.

As corporate information is filed with the Commission, it is intended to afford investors, security analysts and others, instant access to it on home and office computer screens. Edgar will also save time and errors by eliminating the frequent need to transfer data manually from one format to another; and will enable the Commission's staff to process filings more efficiently. Full scale implementation of Edgar is intended to coordinate with the rapid growth of home computers -- from 16 million today to twice that many in less than five years.

The pilot system accepted its first electronic filing on September 24, 1984. Through February, 466 filings have been received from 144 issuers. They range from General Motors, Exxon, IBM and other major industrial, utility and financial corporations to small limited partnerships. The filings include annual and interim reports, proxy and registration statements, post-effective amendments and other forms. They are filed directly, over telephone lines, on diskettes and magnetic tapes. Public access to the pilot filings is available through terminals in the Commission's Washington, Chicago and New York Public Reference Rooms. Computer generated microfiche is produced overnight, which is two weeks faster than for paper filings.

Staff reviews are also faster because information is available instantly at work stations, rather than through manual delivery of microfiche or paper copies; and the staff has immediate access to external data-bases, which expedites research of complex legal, accounting and other matters.

The benefits to issuers are that their filings are received, processed and disseminated faster. General Motors Acceptance Corporation has indicated that Edgar has enabled them to respond rapidly to changing market conditions and get to the market faster. Electronic mail and fee payment capabilities have been added; and the Commission is experimenting with image processing and encryption devices. Edgar filings will also be simultaneously transmitted to all the state securities commissions, the securities exchanges and the National Association of Securities Dealers, Inc. California, Georgia and Wisconsin are already receiving Edgar filings.

Additional pilot projects underway within the Commission, include the use of computer work stations by:

- the Investment Management Division for investment company and public utility filings, and to review investment company and adviser inspection reports;
- the Enforcement Division to analyze trading patterns, mark-ups and mark-downs; and
- the Chicago Regional Office to support enforcement investigations and process small issuer filings.

The Commission is proceeding with a view to phasing all SEC registrants into a fully integrated system beginning in 1986 and ending in 1988.

Telecommunication technology has already had a dramatic impact on the domestic and international securities markets. It has permitted global trading in world class securities; high-speed electronic execution and confirmation of the record volumes of securities transactions and financings; and multimillion dollar savings, through the use of electronic book-entry delivery systems. Edgar is the next step. It has the potential to improve the manner in which investment decisions are made and executed, and the efficiency and fairness of the securities markets.

B. Enforcement

The 299 enforcement actions initiated in fiscal 1984 involved 128 cases alleging misconduct by broker-dealers, investment advisers and other regulated entities; 48 cases alleging failure to register securities offerings; 36 cases alleging issuer fraud and reporting violations; 33 cases alleging financial disclosure violations by issuers and their employees; 18 cases alleging misconduct by accounting firms, their partners and employees; 13 cases alleging insider trading; 12 cases alleging market manipulation; and 11 cases arising out of changes in corporate control.

C. Insider Trading Sanctions Act

The Commission proposed this Act, which was signed by the President in August. Most inside traders have only been compelled to disgorge their profits, which has not been much of a deterrent. Now they will be subject to fines, up to three times their profits. Criminal fines for violations of the securities laws were also increased -- from the $10,000 established 50 years ago, to $100,000 per count.

D. Revised Shelf Registration Rule

This rule has increased the largest and most creditworthy corporations' financing flexibility and reduced their expenses, for the benefit of their shareholders, by hundreds of millions of dollars per annum, without compromising full disclosures. These large savings are principally due to keener competition among underwriters, and among institutions which purchase the bulk of such issues, whether under shelf or conventional offerings. The Commission is continuing to monitor the effects of the rule and will take appropriate action, if warranted.

E. Proxies and Mutual Fund Prospectuses

Simplification and improvement of these documents have reduced their cost and increased their utility to investors.

F. New Options

As a result of Congressional action implementing the SEC/CFTC Accord, new options and futures permit investors and corporations to hedge stock market, foreign currency and other risks at a fraction of the cost of prior means of hedging or reducing such risks.

G. Intermarket Surveillance

At the Commission's initiative, the exchanges are installing electronic intermarket stock and options surveillance systems and transaction audit trails for the quick identification of inside traders and market manipulators. Audit trails also reduce transaction reconciliation costs, ultimately borne by investors.

H. Budget

Registration, transfer and other fees collected by the Commission exceeded its budget by 29%. In the past two fiscal years, such fees have exceeded the Commission's budget by over $35 million.

I. Shareholder Communications

Rules proposed by the Commission in 1984 will telescope the time and expense of corporations' communications with their shareholders, by requiring brokers to provide corporations with the identity of those shareholders, who do not object. Legislation proposed by the SEC would authorize the Commission to adopt similar rules for banks. The Commission continues to support this legislation and requests that Congress act on it during this Session.

J. Bush Task Group

The recommendations of Vice President Bush's Task Group on Regulation of Financial Services include consolidation within the SEC of the filings of all publicly owned banks and thrifts and other major legislative initiatives for the benefit of investors and depositors. The Commission supports the Task Group's recommendations.

K. Foreign Investment Companies

In January of 1984 the Commission recommended that the Investment Company Act of 1940 be amended to make it easier for the Commission to permit an operating foreign investment company to register under the Act and sell its shares in the United States when the Commission finds this to be consistent with the purposes of the Act and the protection of investors. The Commission recommends that Congress consider this proposal.

L. SIPA Amendments

The Securities Investor Protection Corporation ("SIPC") has proposed legislation, which Chairman Dingell has introduced, to amend the Securities Investor Protection Act of 1970 ("SIPA") in order to preserve the jurisdiction of bankruptcy judges over SIPC liquidations of insolvent broker-dealers and to make other changes in SIPC liquidation procedures. The Commission supports these objectives.

M. Technical Amendments

In 1983 at the request of Chairman Wirth the Commission proposed the Securities Law Technical Amendments Act, which would have made various technical changes and conforming amendments in the federal securities laws. The Commission requests that Congress consider a similar technical amendments bill during this Session.

N. Conclusion

The 50th Anniversary year results are a tribute to the Commissioners and the fine men and women who serve throughout the agency. In addition to ongoing programs, the future offers the prospect of major improvements in the regulatory structures of the financial service industries and the exciting potential of high speed electronic dissemination and analysis of corporate information.

II. DISCUSSION

A. Budget Authorization for Fiscal Years 1986-1988

The Commission seeks authorization for appropriations in the amounts of $113.6 million in fiscal 1986, $116 million in fiscal 1987, and $121.8 million in fiscal 1988, in order to cover rising costs, to implement prospective legislation, and to upgrade the Commission's mainframe computer.

The Glass-Steagall Act amendments and the recommendations of the Bush Task Group on Regulation of Financial Services, permitting banks to underwrite municipal revenue bonds and mortgage-backed securities and to sponsor and distribute mutual funds and requiring publicly-owned banks and thrifts to file with the SEC, would significantly increase the number of broker-dealers and investment companies subject to SEC supervision, and the volume of filings with the SEC. Additional staff will be required to review and comment on these filings and requests for interpretations, to conduct cause and oversight examinations, and to enforce the securities laws.

Personnel expenses for the Commission's current staff will rise appreciably due to federal pay increases projected by OMB for fiscal 1987 and 1988. Additional costs would be generated by mandatory merit payouts, within-grade increases, and the need to annualize the salaries of new staff. Nonpersonnel expenses will rise due to inflation and the need to upgrade the Commission's mainframe computer.

The three-year authorization is needed to strengthen the Commission's ability to fulfill its mandate. Ensuring investor protections, facilitating capital formation, and accommodating market changes are goals requiring long-range planning and multi-year commitments. Projects designed to reach these goals, such as the electronic disclosure system and the productivity improvement programs, are multi-year efforts. A three-year authorization is needed to define the fiscal parameters within which the Commission can implement these projects and its ongoing efforts.

B. Legislative Proposals

1. Bush Task Group Recommendations

During the past four years, in Congressional testimony, speeches and discussions with the chairmen of the House and Senate committees concerned, the Commission has recommended that financial services be regulated by functional activities, rather than by outmoded industry classification; that overlapping, duplicative, and conflicting regulatory activities be consolidated; that excessive regulations within and between agencies be eliminated; and that a one-year task group be formed to refine and assist Congress in the implementation of such concepts.

The Commission participated in the Bush Task Group, which has made such recommendations. The main proposals affecting the Commission would repeal the exemptions in the Securities Act of 1933 for registration of securities issued by banks and savings and loan associations and would consolidate, within the Commission, administration of the periodic reporting, proxy solicitation and short-swing profits provisions of the Securities Exchange Act of 1934 as they relate to such institutions. The Federal Reserve Board, the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board presently administer such regulations for different categories of banks and thrift institutions. The SEC administers such regulations for all other publicly-owned corporations, as well as for bank and thrift holding companies. Consolidation within the SEC will permit more uniform and efficient administration and enforcement of these disclosure and other requirements.

The Task Group recommendations also include amendments of the Securities Act to broaden the authority of the Commission to grant exemptions from registration deemed to be in the public interest; exempt from registration securities issued in connection with conversions of banks into holding companies, where the security holders will have substantially the same rights and interests as before; repeal the Public Utility Holding Company Act; and implement other measures intended to simplify improve and increase the cost-effectiveness of the regulation of the securities, banking and thrift industries.

2. Shareholder Communications

Last year the Commission proposed legislation that would amend Section 14(b) of the Exchange Act to authorize the Commission to regulate the dissemination of proxy materials by banks, associations and other entities in the same fashion as the Commission now regulates the dissemination of proxy materials by broker-dealers. It was introduced in both houses of Congress and was added to the Tender Offer Reform Act by the House Committee on Energy and Commerce. The Commission continues to support this legislation and requests that Congress act on it during this Session.

This legislation would permit the Commission to adopt regulations, similar to those that will become effective January 1, 1986 for broker-dealers, to require that banks provide corporate issuers with the identity of their shareholders who do not object.

3. Foreign Investment Companies

Section 7(d) of the Investment Company Act currently prohibits a foreign investment company from offering its shares in the United States unless the Commission issues an order permitting it to register under the Act and to make such an offering. Section 7(d) requires that the Commission make certain findings before issuing such an order that cannot be made in the case of most foreign investment companies. As a result, foreign companies are denied access to American capital markets, and American investors are denied the opportunity to make such investments.

In February of 1984 the Commission recommended that the Act be amended to make it easier for the Commission to permit an operating foreign investment company to register under the Act and sell its shares in the United States when the Commission finds this to be consistent with the purposes of the Act and the protection of investors. The Commission recommends that Congress consider this proposal.

4. SIPA Amendments

The Securities Investor Protection Corporation has proposed legislation, which Chairman Dingell introduced on February 28, to amend the Securities Investor Protection Act in order to preserve the jurisdiction of bankruptcy judges over SIPC liquidations of insolvent broker-dealers. The Bankruptcy Amendments and Federal Judgeship Act of 1984 permits a party to seek to have a particular proceeding relating to customer claims decided by a district court judge rather than by a bankruptcy judge, resulting in possible bifurcation of SIPA proceedings. The proposed SIPA amendments are intended to assure that bankruptcy judges generally would decide these customer claims.

In addition, the amendments would give SIPC an automatic right to participate in related state court proceedings. This is important because the bankruptcy amendments encourage the abstention of federal district courts on state law claims or causes of action related to bankruptcy cases. Finally, the proposed amendments would change existing law relating to the manner in which aggrieved customers can obtain judicial review of determinations in direct payment proceedings under SIPA. The amendments would permit only district court judges, rather than bankruptcy judges, to review these determinations.

The Commission supports these objectives.

5. Technical Amendments

In 1983 the Commission proposed the Securities Law Technical Amendments Act to make technical, clarifying, and conforming amendments to the securities laws. The bill, introduced as H.R. 4574 of the 98th Congress, was sponsored by Chairman Wirth and co-sponsored by Chairman Dingell. The Commission staff prepared the bill after Chairman Wirth requested legislative proposals to eliminate anomalous and outmoded provisions of the securities laws during the Commission's authorization hearing on February 15, 1983.

The Commission is now proposing a similar technical amendments bill, the Securities Law Technical Amendments Act of 1985. The Commission believes that all of the proposals in the new bill are noncontroversial. The great majority are technical corrections eliminating typographical errors and obsolete and ineffective provisions. For the most part, the provisions are identical to those found in H.R. 4574. The bill's more substantive provisions include the following:

First, Section 105, which was contained in H.R. 4574, would eliminate a possible form of discrimination against savings and loans as compared to banks, by deleting the condition applicable to savings and loan associations that, for their securities to be exempt from registration, they not change certain entry fees.

Second, Section 209, which was also included in H.R. 4574, would give the Commission authority to decline to accept payment of fees in cash, thereby reducing security problems and eliminating the need for separate accounting records.

Third, Sections 219(1) and (2), 509, and 602(1), (2), and (3), which are new, would permit the Commission to impose administrative sanctions on persons already within its jurisdiction for misconduct relating to transfer agent activities. These amendments also would substantially conform the disqualification and sanction provisions in the Investment Company and Investment Advisers Acts to those in the Exchange Act. This would permit the Commission to impose administrative sanctions for misconduct arising out of activities in the municipal securities and commodities markets on investment advisers and persons associated with investment advisers, as well as on the management of investment companies. In a similar vein, Section 221 would conform the sanctioning provisions applicable to municipal securities professionals to those applicable to other securities professionals by authorizing the Commmission to "place limitations" on the activities of municipal securities professionals.

Fourth, Section 223, which was included in H.R. 4574, provides for self-regulatory organization access to the complete results of fingerprint identification processing.

Fifth, Section 224, which is new, would expand authority of the Commission and the federal bank regulatory agencies that regulate transfer agents in three primary ways. First, the agencies would be authorized to bring administrative proceedings against professionals associated with the transfer agents they regulate. Second, it would expand the grounds for sanctioning transfer agents in administrative proceedings to include convictions and injunctions relating to financial services industry activities and violations of the securities laws in addition to Section 17 and 17A of the Exchange Act. At present, the grounds for imposing administrative sanctions on transfer agents include only violations of, or inability to comply with, Sections 17 and 17A and the rules thereunder, which relate to recordkeeping and clearing and settling securities transactions. Third, Section 224 would allow the agencies to bring administrative proceedings against a transfer agent for acts of professionals associated with the transfer agent.

The Commission recommends that Congress give favorable consideration to this legislation.

Mr. WIRTH. Thank you very much, Mr. Chairman, and I suspect there will be a variety of questions related to ESM.

What I would like to do in the 5 minutes available to me is review, if I might, the history of our discussions about ESM, which I think raise some disturbing questions about the responsiveness of the SEC to the U.S. Congress.

As you may recall, we discussed this issue, Chairman Shad, in the hearing a year ago in February. We discussed Drysdale, and the fact that the SEC has antifraud authority over the sale of securities, but has no regulatory jurisdiction over firms that deal only in Government securities.

Just before that hearing, on January 25, Chairman Dingell and I wrote to you and asked you for policy recommendations as to what the Commission would need to strengthen its authority overall. We noted that we are in a rapidly changing financial environment, and asked if there were any changes necessary. That was on January 25.

On April 27, we received back from you a very lengthy letter, which was a marvelous legal analysis of the existing law, but which left unanswered the questions which Chairman Dingell and I had posed to you in January.

On May 8, Chairman Dingell and I wrote to you again and asked you once more the same questions that we had asked in January: What should be done, in your opinion, to strengthen the law. Was more authority needed. Was more before-the-fact rather than after-the-fact authority needed.

That letter went to you, Mr. Chairman, on May 8, 1984. We had the pleasure of waiting for 8 months until December 21, 1984, at which time we got back from you a 2-page letter which effectively said, and I will quote, "The Commission has no day-to-day involvement in the Government securities market, but the antifraud provisions of the Federal securities laws apply to this market." It was a nonresponse after 8 months.

Then on January 23, I wrote what I thought was about as tough a letter as I could put down on a piece of paper. I said:

> After a delay of almost 8 months, I have finally received your reply to the letter that Chairman Dingell and I sent you last April. In the letter, as in its precursor dated January 25, we raised serious policy questions concerning the municipal and Government securities markets. The brevity of your response leaves our substantive questions unanswered.
>
> While I will assume that this lack of forthrightness was in no way intended to signal a lack of cooperation with the Congress, I have to wonder why the Commission appears to be unwilling to assist this committee with important policy concerns.
>
> Public policy is not formulated in a vacuum. It is irresponsible for the agencies charged with the regulation of these markets to pretend that Congress has no role in assessing current regulatory schemes governing municipal and Government securities markets. The public deserves better.
>
> Ongoing legal investigations do not render the Commission powerless to make policy related recommendations.

After that letter, you and I had a telephone conversation. Following that conversation, the Commission sent a letter dated the March 12, 1984, which again said that there were problems in this area, but again did not address the basic question: Was it necessary for us to move in the Congress and address this issue by strengthening the law.

Your letter of March 12 did not answer that. There were five pages of discussion of the Government securities industry, but no specific recommendations.

I have given you the very unfortunate history of a year of nonresponsiveness over an issue the Commission has known of since 1977. We have asked you if the Commission needs further authority beyond the fraud statutes in this area. We have still not received a response to that question.

I would like to ask each of the Commissioners—those who weren't on the Commission obviously can't go back that far—if, one, you were aware of all of this correspondence that was going back and forth over the past year. Second, were you aware of the nonresponses that we were getting from the Commission. And third, were you aware of the March 12 letter.

Maybe I could start with you, Mr. Shad. And I'm sure you are aware of this year of correspondence, and you are aware of all of these letters that went back and forth, correct.

Mr. SHAD. Yes.

Mr. WIRTH. And were you satisfied that you were answering our questions over this year period of time.

Mr. SHAD. To the best of our ability, yes. I think the efforts that we put in were very serious and intended to be responsive.

Mr. WIRTH. Was there any time in any of your responses in which you answered the question which Chairman Dingell and I asked you: Did the Commission need greater authority over the Government securities area. Is that answered in any of the correspondence, starting in January 1984 through March 1985.

Mr. SHAD. Our response was that we do have jurisdiction over the fraud in the marketplace. We do not have jurisdiction, and we are not the primary regulator——

Mr. WIRTH. Let me ask you the question again. The question that Chairman Dingell and I asked you just now and we asked you for 1 year and 2 months: Did the SEC need greater authority. Did you answer that question anywhere in those letters.

Mr. SHAD. No, I didn't. And I, even sitting here today, have difficulty in responding to it, and I would be glad to amplify the reason.

Mr. WIRTH. Do you need more authority, yes or no.

Mr. SHAD. I can't answer yes or no.

Mr. WIRTH. Obviously you can.

Mr. Treadway, can I ask you, were you familiar with the history of this correspondence.

Mr. TREADWAY. Well, I am not, Mr. Chairman. I don't recall whether I saw the letters or not as they came in or the staff response. But we did not, as the Commission, as a body, at any time act to deliberate the particular questions that you posed. And you will note, in the March 12 letter, there is a footnote that said: "One Commissioner has not formed a conclusion on these matters," the substantive positions that were taken in the March 12 letter, and that was me, because I did not feel that we had addressed these issues as a body, having been fully briefed by the staff, and had the opportunity for debate and dialog among the Commissioners.

Mr. WIRTH. And you felt these were important issues that, as a group, you should address.

Mr. TREADWAY. Before taking substantive positions, yes.

Mr. **Wirth**. Mr. Cox.

Mr. **Cox**. I was aware of correspondence going on, the questions you'd asked, your response, and the March 12 letter. Yes; I had read it before it came up here.

Mr. **Wirth**. You had read the March 12 letter. Did you agree with what was in that letter as a response to the questions that we'd asked about the need or the potential need for greater authority at the SEC.

Mr. **Cox**. Yes; I was aware of the response, and I agreed with the idea that it was not conclusive. It was not clear that we required greater authority.

Mr. **Wirth**. Commissioner Marinaccio.

Mr. **Marinaccio**. Congressman Wirth, I believe that since the time that I have been there, I have been aware of the correspondence that has gone out. We haven't had a meeting on it, but I think the documents do circulate seriatim, and we all sign off on them, any correspondence that comes back to the Hill.

Let me say, if I may offer this: I personally believe that Congress has the greatest role in developing rules and regulations to govern the Government securities market. And I don't sense any desire whatsoever on the part of any Commissioner to temporize in any way the severity of the ESM failure.

I think that it is awfully complicated, and I think the committee should move ahead on it with hearings, and call people up, and so on, and so forth. But I think we ought to bear in mind that we are dealing here in the Government securities market with the preeminent position of the Federal Reserve in conducting the monetary policy of the country.

Monetary policy, as all the members know, is conducted by the Federal Reserve in purchasing and selling Government securities in the open market. So the Federal Reserve has an important role to play in the governance of the Government securities market.

Now I think the SEC has an important role to play, too. But I don't think it is for the SEC to go ahead and make recommendations in the absence of a full discussion of the issue.

Mr. **Wirth**. That really begs the issue, though, doesn't it.

The Federal Reserve does not regulate Government securities dealers, does it.

Mr. **Shad**. Yes.

Mr. **Marinaccio**. Well, the Federal Reserve has for a period of time been, since Drysdale, been discussing inside the Federal Reserve System what kind of voluntary capital ratios it should place upon Government securities dealers.

Now one may want to fault the fact that the Federal Reserve may be moving toward a voluntary system, and I think the Congress may want to examine whether or not a voluntary system or a statutory-based system is the proper mode.

All I'm saying in my response is, this is a very complicated matter. It doesn't only concern the Securities and Exchange Commission enforcement of Government securities dealers, but it also concerns the monetary policy of the country, and I think the Federal Reserve ought to be considered and brought into this, and it ought to be a cooperative matter between the SEC and the Federal Reserve and the Treasury Department.

Mr. **Wirth**. Well, that is helpful.

Mr. **Marinaccio**. With the Congress having the preeminent role, of course.

Mr. **Wirth**. Absolutely; and that is what we were trying to find out from the SEC. We have asked for recommendations as to what ought to be done. We're in a situation where the SEC regulates most securities dealers, and municipal securities dealers. The Fed does have a role in overseeing the primary dealers in Government securities, but not dealers like ESM. There is no supervision by the Fed of dealers like ESM; isn't that correct.

Mr. **Marinaccio**. I'm not sure that the Fed have statutory regulatory authority over the primary dealers. I think it's a voluntary——

Mr. **Wirth**. It exercises that authority.

Mr. **Marinaccio**. Well, they exercise it by—it's a voluntary system, and I would gather that the Fed was considering very seriously enhancing that voluntary system by substantially increasing the form of regulation by applying capital requirements on all Government securities dealers.

Now that represents a substantial step ahead.

Now I completely agree with you. Congress may want to take the position, after it deliberates, that a voluntary system isn't the right system. All I'm suggesting is that it's a very complicated matter, and the Fed——

Mr. **Wirth**. It is a complicated matter. I agree.

Mr. **Marinaccio**. The Fed deserves a place at the table.

Mr. **Wirth**. I agree. In that, we would like to have a response back from the SEC as to your expert advice about what Congress ought to do.

Commissioner Peters.

Ms. **Peters**. Mr. Chairman, I cannot recollect knowing at the time to the extent that there was any correspondence exchanged between you and the Commission after I was sworn in in June, of communications between yourself and the Commission or the Chairman on this topic, however, other than, of course, your letter of January 23 and the response that you received, dated March 12.

I think I do recall that probably copies of past correspondence were attached to perhaps the seriatim memo that provided us with the response of March 12, 1985, and the attached staff report, but I can't tell you that for sure.

I did read our March 12 letter to you and signed off on it. I felt that personally for me the two recommendations in that letter that recommended that we do take action to, to a certain extent, expand our authority or oversight of this area were steps in the right direction. And in reviewing the staff report that was sent to you, I viewed that as an explanation of the far-reaching and wide-ranging difficulties that both the Commission and, of course, Congress would have to view and consider in taking any steps in this area.

My personal inclination is that we do need more power, and we should be more active. However, I don't think—I don't view the staff report as temporizing. I think that the Commission has taken a cautious, careful look at it, and this report, of course, was prepared, I think, before ESM.

Mr. **Wirth**. All of this correspondence occurred well before ESM, as you are aware, Mr. Shad, and we have been going back and forth on this now for 14 months. We anticipated that there could be very real problems out there. We talked about this in the hearing of February 1984, and here we are again today with no recommendations from the SEC, and very little in terms of responses to our questions.

It has been my hope that the Commission would meet expeditiously on this subject, take this matter very seriously, and get back to this committee as expeditiously as possible on what your recommendations are on Government securities: Should there be further regulation of the dealers in Government securities, as you regulate other securities dealers in this country.

If so, what kind of additional authority should you have.

I think that is the issue we've been asking you about. Maybe our correspondence was not clear.

Mr. **Shad**. Oh, it was. Substantially, everything you have said, I agree with. I would like to amplify.

Mr. **Wirth**. Please do.

Mr. **Shad**. I wasn't able to give a yes or no to the question you raised earlier, and the problem is that the Government bond market is a multitrillion-dollar market. And the SEC——

Mr. **Wirth**. It seems to me, that is all the more reason for there being a yes or no answer.

Mr. **Shad**. Well, let me go on in terms of the consequences of regulation and how you would appropriately approach those problems. I hope that, in the course of today's discussion, we will be able to discuss specific alternatives and approaches to the ESM situation.

First, all of the correspondence that you have received has been circulated to all the Commissioners who were present at the time. And any Commissioner or any senior member of the staff can request a Commission meeting or hearing on anything, and, you know, by and large, there are no problems in calendaring any of these items.

It is so far beyond any of our existing responsibilities that it is a question of whether or not you want to further fractionalize the regulation of the securities markets. There is an effort to go to functional regulation. We have been a strong advocate of that. Do you want to inject into the system now—you have the Fed in there, and definitely regulating the 36 primary Government bond dealers, and they have been responsive to the Drysdale situation.

One of the problems there was that you're dealing in massive amounts of money and very thin margins. Drysdale was the failure to account for the accrued interest that Drysdale was owing to the other side, and that amounted to—I think it was close to $100 million.

The Federal Revenue has addressed that. They've come in with voluntary guidelines on net capital ratios. The SEC's staff has been working closely with them, and the as guidelines are very similar to our existing rules, as they apply to broker-dealers for whom we have set capital ratios.

We are continuing to work with the Fed—we're having meetings coming up very shortly with them to get into how well this is working in the light of ESM. There are several other alternatives, and I certainly have never suggested—as I believe you mentioned, Mr. Chairman—that Congress has no role. I don't agree with that at all. I think it is precisely the issue for Congress to get into all the various factors. It's an enormous policy area for congressional consideration, and for any one agency, it's like having one hand on the elephant; we aren't sure of all the pieces that are involved here.

But it goes directly to the heart of the Nation's monetary and fiscal policy. It involves not just the ESM's of the world; it involves almost all of the major corporations in America who are buying, and selling, and dealing in Government securities—it's the most liquid securities market the world has by far ever known. It's incredible, the Government market. It's an incredibly efficient one.

And now I come to sort of the heart of it. From the SEC's point of view, you know, frauds do still occur among the broker-dealers that we regulate very intensively and vigorously. And when you hit the fraud area, the question is, could you have caught it, could you have observed it, could you have exposed it. We've had some disasters, if you will, within SEC-regulated broker-dealers. Although we do get into other areas, basically we're regulating the broker-dealers who deal directly with the public.

The Government bond dealers typically deal with other professionals. In this case, it was S&L's, and school districts and other institutional-type parties. ESM wasn't dealing with the unsophisticated investing public, which is the area of most intensive regulation by the SEC.

Mr. **Wirth**. I just think it's difficult to assume that a school district in Ohio, or Texas, or whatever is going to know about the net capital requirements of a Government securities dealer or would know if they're keeping accurate books, and records, or whatever.

I would think that is your responsibility. The responsibility of a little preventive medicine, rather than fixing the patient with an enormous fraud, securities fraud, operation which you're into now.

Mr. **Shad**. If people give you fraudulent financial statements—and we brought the fraud action against the managing partner of the south Florida office of Alexander Grant yesterday——

Mr. **Wirth**. Oh, I realize that. But again, that patient is sick; you fix the patient after he gets sick. The point that we are making is that there may be a good deal that should be done beforehand. That's what we wanted to hear from you about in any case.

Mr. Rinaldo.

Mr. **Rinaldo**. Thank you, Mr. Chairman.

I want to follow up on that line of questioning. But first, Mr. Chairman, without detracting from the time available to me, I would like to introduce into today's record the following legislation: H.R. 1602, the SEC Budget Authorization Act; H.R. 1603, the Shareholder Communications Act; and H.R. 1604, the Securities Law Technical Amendments Act, which you and I cosponsored and which were introduced on the floor of the House yesterday.

Mr. **Wirth**. Without objection, those will be included in full in the record.

[See pp. 14–52.]

Mr. **Rinaldo**. Mr. Chairman, I believe that in the correspondence that you have been alluding to with the subcommittee, that the SEC urged Congress to hold off on legislation that would regulate the Government securities market, because several Government agencies are working to resolve problems in this area.

And I would like to know what types of regulations or Government oversight should be imposed upon companies that trade in Government securities to prevent another failure like ESM.

Mr. SHAD. Well, as far as the ESM, that's exactly what we're testing in terms of the Fed's existing guidelines, and we're asking, would this have precluded an ESM.

The SEC moved incredibly fast on this and brought the actions. But for the SEC's efforts, the staff's efforts, the situation would have been a hell of a lot worse than it is today. It could have gone for a longer period of time and been even worse.

There are several ways to approach this type of problem in terms of oversight and in terms of regulatory structure. I have to say very frankly that when you hit fraud, if you have enough people in collusion doing things, it's very difficult to find out about it up front. And if you look at the record of the Securities and Exchange Commission over the past 50 years, we're like the cop on the beat who is responsive to changing market conditions and problems, and we try to provide, and we do provide, a very visible presence through the publicity of these outrageous cases that we've successfully prosecuted to inhibit others from engaging in the activity.

But I think instead of demeaning the Commission's record, it ought to be lauded. It has been incredibly effective in terms of exposing and prosecuting cases, and that very thing is what we're authorized to do by the Securities Act. This is why we're so effective, I believe, in terms of the extraordinary ventilation, and exposure, and the public's responses to these outrageous situations.

Over $100 million of this could have been avoided if the S&L's and other customers had demanded delivery electronic book entry delivery. They didn't collateralize. People are buying million-dollar pieces of paper without ever having any evidence of ownership, except a fraudulent confirmation from ESM.

I don't think any of us, no matter how experienced one is in investments, would take lightly whether or not you should, in fact, have some evidence or confirmation of your ownership. Normally, it's by either receiving a physical piece of paper that's a security, that you have reason to believe is not counterfeited—although there have been instances of counterfeiting—or through book entry, which is the effort that the SEC is now engaged in—to dramatically accelerate book entry delivery systems, which in this case, properly administered, would have saved a major portion of this loss. In other words, it wouldn't have gotten to the point it did.

The other piece of this big loss was overmargining, or providing more than enough margin, by two S&L's, American S&L in Miami and Home State in Cincinnati, in which one individual had very substantial controlling interests. So one effect, by providing more margin than is normally provided—over twice as much as is normally provided—it was able to create liquidity in ESM to give it ability to continue to deal with this paper. I can't go too far, because this is a major area of continuing inquiry, and we've got actions pending. But there are things that just in the course of our present efforts we know could have prevented some of this problem.

Mr. RINALDO. If I may, Mr. Chairman, let me ask you a question. You said you have actions pending. You mentioned what can be done after the fraud has occurred. You talked about Federal guidelines, which I believe aren't mandatory.

Let me ask you a very key question, in my view: Now that the problem has been brought to light, has the case been referred to the Department of Justice for criminal prosecution.

Mr. SHAD. I believe they're in, but I will have to ask the general counsel.

Mr. GOELZER. My understanding is that the Department is definitely aware of the case. We haven't made a formal referral.

Mr. SHAD. You don't need to in a case like this.

Mr. MARINACCIO. My understanding is that the FBI is down there investigating.

Mr. LYNCH. We've had discussions with the Department of Justice.

Mr. RINALDO. You've had discussions, but has it been formally referred.

Mr. LYNCH. They have submitted a request for access to our files, and it is going to be granted.

Mr. RINALDO. Let me ask one more question. I know my time has run out as a result of the lengthy answer you gave to the previous question.

What I'm trying to evoke here is some manner in which action can be taken by the SEC prior to the occurrence or discovery of the fraud. And I would appreciate your suggestions there. For example, should the role of the Municipal Securities Rulemaking Board be expanded to include jurisdiction over Government securities dealers. Do you have any other suggestions or recommendations at this time to what we can do, and who is ultimately responsible for the fraud that has been perpetrated on the customers of ESM.

I don't think we can just walk out of this hearing and say, "Well, nothing can be done. Nothing can take place until the fraud actually is discovered or after it occurs."

I know that's a difficult question to answer.

Mr. SHAD. Yes, it's very difficult. It is very logical to raise the issue of whether we should have expanded Government securities regulation either within the MSRB, or another GSRB that would have similar oversight responsibility over the Government market that the MSRB has over the municipal market.

But I have to tell you that I don't believe that under these facts, as we know them at this moment in time, the MSRB-type structure or even the more pervasive direct regulation by the SEC, would have exposed and prevented this—I mean, it would have exposed it, as we did. We may have caught it much earlier, which would have been much more desirable.

But when you get into a conspiracy involving fraud—and involving a lot of people, the question is, can you discover that. And obviously, we've had such cases—Bell & Beckworth was an enormous fraud. So was Stix & Co. Both were under our direct regulation. And I think we did an excellent job there. The New York Stock Exchange found it through its oversight investigations. We have the NASD involved in many of the firms to do its investigations, and then we also do ours, not only oversight but direct investigations, and we've discovered these things.

I think the visible presence and the intensity of our efforts is a major inhibitor of this kind of conduct. But I can't say that on these facts, as ESM exists before us today, that we could have prevented it from ever happening up front. If people are willing to engage in fraudulent activity—and we're now charging the managing partner of the south Florida office of the accounting firm that certified their financial statements, as well as an awful lot of other people, involved in what I have to frankly tell you is, in my opinion, a pure fraudulent conspiracy—then they're able to get away with it. Other companies have, as a matter of fact—such as Fund of Funds and various other situations where people have gotten away with fraud for a period of time.

Mr. RINALDO. Mr. Chairman, I know my time has expired, but I would like to make a unanimous consent request that the question that I just asked remain open for deliberation by the Chairman and the full Commission, so that we can have a more complete answer to that question and to related question such as what the SEC can do to prevent another ESM, and whether or not, as the Chairman mentioned, a self-regulatory organization along the lines of the NASD is needed, or what other approach the Commission, the full Commission, would recommend.

I think this is a serious enough matter that we shouldn't rely just on the Chairman's answer at this hearing, and I would request that the full Commission be convened at a meeting at the earliest possible date, at which time the question can be explored in depth, and an immediate response be sent to the members of this committee for inclusion in the record.

Mr. LUKEN [presiding]. Without objection, although I can't imagine a longer answer. You mean a more complete answer.

Mr. RINALDO. A more complete answer.

Mr. SHAD. It involves so many things beyond our ken. We are not experts in this market. There are others that have primary responsibility for segments of it. Are you suggesting that we would also have our own hearings to elicit much more information than we have within our normal operation.

Mr. RINALDO. What I have been able to conclude or deduce thus far is that obviously at this hearing this morning, which will certainly go into this afternoon, we're not going to be able to obtain from you folks the answers to what I consider the key questions. And that's why I introduced that unanimous consent request, that I would hope that you would draw upon whatever resources are used, whatever methods you feel will best enable you to give us the type of answer that I'm sure you recognize the members of this committee feel is necessary, so that we can properly proceed with any type of legislative action that may be needed.

Is that sufficiently clear now.

Mr. SHAD. Yes, I understand the question. Thank you.

Mr. RINALDO. And I will also attempt to see to it that the same inquiry is made at a subsequent meeting of the Banking Committee.

Mrs. COLLINS. Mr. Chairman, reserving the right to object.

Mr. Chairman, I will not object. However, I think the question that was made by the gentleman from New Jersey was that this be done, but there is not a time certain.

My concern is that this can drag on and on and on, and I wonder if it's possible to put a date certain by the time this information should be received by us, whether it's a month or 60 days or 90 days or whatever it is.

Mr. RINALDO. I think that's an excellent suggestion.

Mr. LUKEN. Would 30 days be agreeable with everyone.

Mr. RINALDO. I think 30 days might be a little tough for a question of that magnitude.

Let me ask the Chairman——

Mr. LUKEN. You're describing your question as enormous.

Mr. RINALDO. We want the response obviously as expeditiously as possible. What would be your recommendation for a time limit, so that we can have a date certain, which the gentlelady requested.

Mr. SHAD. In terms of the kind of effort which this would involve, where we have to get a lot more input from other Government agencies—Treasury and the Fed and others—to come up with any considered recommendation, in my opinion, I would say a bare minimum time period would be 90 days, and even that would be very difficult.

Mr. LUKEN. Would the gentlelady yield.

Mrs. COLLINS. I will yield to the gentleman.

Mr. LUKEN. It seems to me that the time period goes directly to the heart of the question we are discussing. Many of us in this room and outside suggest that we've been dallying too long, and that there are crises brewing out there, even beyond the present crisis, and therefore I think the time question is important, and I would suggest to the gentlelady that perhaps 90 days might be too long.

Mr. RINALDO. Well, I was going to respond in this fashion, if I may reclaim my time.

You've mentioned 90 days. I think 90 days, when you consider the effort that has to go into this to produce the kind of result that we want is probably the amount of time that is required. But suppose we change that to 90 days for a full report and 30 days for an interim report.

Mr. SHAD. You're dealing with the monetary and fiscal policy of the United States of America, trillions of dollars and thousands of individuals, corporations and others, dealing in these markets. There have been articles written by responsible publications, saying "Don't act rashly."

Mr. RINALDO. Let me respond in this fashion. I picked 90 days because you are the one who suggested 90 days.

Mr. SHAD. As a bare minimum. In my opinion, 90 days is necessary to give you any kind of a considered reaction and that would be an intensive effort of a great number of people, both within the SEC and outside of the SEC.

It would necessitate our bringing in a lot of experts that we do not——

Mr. LUKEN. All right, that is fair enough. I am willing to go along with the 90 days.

Mrs. **Collins**. Mr. Chairman, I am too, and for that reason I will withdraw my objection.

Mr. **Luken**. The record will be closed, without further objection, in 90 days because the gentleman's time has expired.[1]

Chairman Shad, would you agree with the statement that has been made quite frequently, recently, publicly, that the Government securities business is a volatile business.

Mr. **Shad**. It is hardly the right word. Government bonds are not volatile securities, but when you buy them on 1 percent——

Mr. **Luken**. But we are not talking about whether—That is the point. I am glad you made that. We are not talking about whether they are volatile securities but the business can be volatile.

Mr. **Shad**. It can be very highly leveraged, yes.

Mr. **Luken**. Now, something you said before bothered me a little bit. You are not suggesting that your oversight monitoring of regulated brokers is ineffectual, are you.

Mr. **Shad**. By no means, I think it is essential that——

Mr. **Luken**. Your argument that you do not want to regulate the Government securities dealers because, after all you will not be able to detect all fraud because, you are now having losses within your regulated industry; does not mean that you cannot effectively prevent some of these breakdowns——

Mr. **Shad**. You know, we are not perfect, but I believe that the systems that the SEC employs are extremely effective, yes. But I am not sure that the approach that is being suggested is cost effective. I do not know what the——

Mr. **Luken**. I understand that you are not sure. You were not sure last year and you were not sure the year before. We think, many of us, that we have to do something.

Now you said that, in your testimony, that the situation would be a hell of a lot worse if the SEC had not moved on March 4. Is that your testimony.

Mr. **Shad**. Yes, sir.

Mr. **Luken**. In other words, a hell of a lot worse. Now, we have already observed that the value of the dollar has been shaken internationally. What would be a hell of a lot worse, 1930, 1890. What do you envision as a hell of a lot worse.

Mr. **Shad**. I meant compounding this felony. In other words, instead of $300 million, it could have gone on to much higher numbers.

Mr. **Luken**. So those repercussions——

Mr. **Shad**. They are broader than the State of Ohio impacts. It could have had much more serious impact than it has had.

Mr. **Luken**. But we have had a broader impact than the State of Ohio, have we not.

Mr. **Shad**. Yes, right, we certainly have, but it could have been even broader, that is all. You add another $100 million to this type of phony paper out there, you could have brought down other S&L's in other States and——

Mr. **Luken**. They are there for—it is for the grace of God therefore, this could have been a real crash.

---

[1] The SEC report is included in hearings on Regulation Government Securities Dealers (Serial No. 99-38) at page 201.

Mr. SHAD. Well, it could have been worse than it was, yes.

Mr. LUKEN. All right. Now what we are talking about is preventing it from happening in the first place. We are talking about regulation by the SEC, which afterall has the only enforcement authority, right.

The Fed does not have the enforcement authority in reference to broker-dealers does it. Or with reference to the 36, the 36, by the way in SEC, I mean ESM is not one of the 36 primary dealers, right.

Mr. SHAD. Right.

Mr. LUKEN. The Fed does not have any enforcement power there, does it. You have got the enforcement authority, such as it is, as witness the fact that when ESM went bad, it was not the Fed that went in, it was SEC that went in, right.

Mr. SHAD. In terms of fraud in the marketplace, yes.

Mr. LUKEN. Well, that is what we are talking about, isn't it.

Mr. SHAD. I am thinking of other areas of jurisdiction where people could have closed down this operation.

Mr. LUKEN. Well, let us try to keep it simple and just talk about fraud. That is a big enough area, isn't it.

Mr. SHAD. I agree with you, but fraud laws can be enforced by DA's, by a lot of other people besides the SEC.

Mr. LUKEN. Now, if you had the power, 2 years ago or say for the last 5 years, to regulate Government securities dealers and you, therefore, had access to oversight of ESM, you would have detected it before March 4, 1985 would you not.

Mr. SHAD. I believe that our surveillance techniques and the oversight of SRO's that we use in the securities area would have ventilated this situation earlier than has occurred in this circumstance, probably.

Mr. LUKEN. Then you would have prevented something that, there but for the grace of something, might have been the greatest crash since 1930 or 1890. If you had this authority which, many of us want to give you but you are resisting. Why.

Mr. SHAD. No, I am not resisting it at all. I am just saying that the problem I am having with it is that when you have a conspiracy, I do not know for sure whether we would have been able to deal with it. It is a very——

Mr. LUKEN. You are changing your answer. You say you believe, after the question——

Mr. SHAD. Probably, I said.

Mr. LUKEN. I put the premises there and you say, "probably you would have ventilated this before."

Mr. SHAD. Yes. Probably.

Mr. LUKEN. That is a pretty cautious answer. I mean here is a pretty obvious situation. You have got this in your March 4 report here. "This company was having losses of $92 million a year in 1980."

Let me——

Mr. SHAD. Those losses were not in their financial statements. That was one of the problems. They were not reflecting those losses until we got in there and found out what was going on.

Mr. LUKEN. But you could have been in there before if you had the power. That is what we are talking about.

Mr. **Shad**. But I am questioning whether or not when you have a certified financial statement from a major accounting firm, whether we would have detected fraud. Yes, we would have seen concentration; and that would have led us to further questions; and, if they did not come back right, yes, we would have. But for this type of business, it can change literally overnight.

Mr. **Luken**. Let me go back to something else you said, Mr. Shad. You said that you have fine men and women in SEC, conscientious, who are doing a good job.

Mr. Dingell agreed with that and I am certainly inclined to agree with that. In fact I would go even further, as witness, ESM.

ESM, in 1977, different administration, I do not know whether that makes any difference or not, maybe you could tell me. But, in 1977, the agents of SEC went into ESM under a subterfuge because they did not have the authority.

Under a subterfuge, they went in to monitor, to give oversight to ESM because of certain activities and SEC was taken to court. SEC spent the next 4 years in court by ESM putting up obstructionist tactics.

The SEC was charged with using a subterfuge, being tricky, because they did not have the power. That is what this court held, isn't that right.

Mr. **Shad**. May I ask the general counsel to respond. He could amplify.

Mr. **Luken**. This is what you sent to us. I just read what you sent to us.

Mr. **Goelzer**. I do not believe that you characterized it accurately. The Commission issued——

Mr. **Luken**. Which part didn't I characterize.

Mr. **Goelzer**. You said the Commission went in under a subterfuge because it did not——

Mr. **Luken**. The agents did, agents did.

Mr. **Goelzer**. That is not correct, sir. In fact——

Mr. **Luken**. The court said that it did.

Mr. **Goelzer**. The court did not say that. The court said——

Mr. **Luken**. Tricky.

Mr. **Goelzer**. The court said it had to treat the allegations in the complaint as true for purposes of what was before the court. There was no hearing, no finding, and there were denials of those allegations. In fact, the Commission had issued a formal order of investigation which is the document that authorizes the staff to conduct an investigation and that is the basis on——

Mr. **Luken**. Well, if that was not true, how come it deterred the SEC for 4 years and then the SEC, in 1981, withdrew the charge.

Mr. **Goelzer**. We litigated. I do not think we were deterred. We litigated the case for 4 years. The district——

Mr. **Luken**. Oh you say "litigated" and I say "deterred." Now you tell me the difference.

Mr. **Shad**. We could not get enforcement of the subpoena.

Mr. **Luken**. You fought as hard as you could and then you gave up. You were not guilty but you gave up.

Mr. **Goelzer**. We won in the district court. The district court said: "Yes, your subpoena must be enforced." The other side appealed. We have no way to stop them from appealing. By the time the court of appeals resolved the case, 4 years of litigation had passed.

Mr. **Luken**. And an administration changed.

Mr. **Shad**. It had nothing to do with the change of administration, sir.

Mr. **Luken**. Well, I do not say this just out of the blue, but I say this in reference to the background of your approach to the issue.

Mr. **Shad**. The Commissioners had——

Mr. **Luken**. The reason I think it——

Mr. **Shad** [continuing]. In the last 4 years and another administration.

Mr. **Luken**. It was this administration, in 1981, that withdrew the case against ESM and I submit to you that the actions of the SEC agents in going into ESM showed that they were vigilant. They knew there was a problem in ESM.

As a result of the fact that SEC did not have the legal authority, which we would like to give the SEC, the enforcement authority, they got tied up in court for 4 years. Then the SEC withdrew it and so there is no action, no oversight, no monitoring of ESM at a time that it was going bankrupt, that it was double and triple pledging securities, which would have been as plain as the nose on anybody's face.

All of this was going on and the simple answer would be, as you stated just before, that in this particular case, if the SEC had oversight authority, which would be very simple to give by legislation, the whole thing would have been prevented. "Probably," you said.

Mr. **Shad**. The 1977 inquiry was not at all related to what this proved to be. Although, I think that if we had gotten in there, we may have, and I think, probably would have obtained some relevant information because of the subpoena.

Mr. **Luken**. We give you more credit than that. We are sure you would have.

Mr. **Shad**. I also very much appreciate, Mr. Luken, how strongly you feel about this. I am not going to temporize with that at all. I think it is a terribly serious problem. It should be corrected.

But I am also sure you agree with due process of law. If we are blocked from subpoena enforcement by legal proceedings and then an extended period of time transpires, records become old. And then, when we finally succeeded in the courts, and pursued this further; we were talking about something, by then, that was 5 years old.

Mr. **Luken**. And, as you know that is not my main point. My main point is that if you had the legal authority of oversight of this agency, you would not have been in court in the first place and you would have been in there as early as 1977.

In 1978, ESM started to go bad in a bigway. You would have, I am sure, detected it and ventilated it and everybody would have known about it and the whole thing would not have occurred. That is very simple.

Mr. **Shad**. I might ask the general counsel's opinion on that. I am not sure that——

Mr. **Luken**. Well I did not ask the general counsel but I do not object to his answering.

Mr. **Goelzer**. I have no way of predicting whether the Commission would have discovered the fraud or not. The item that was being investigated at that time was improper markups. It was not directly related to what turned out to be the fraud.

Mr. **Luken**. But that is the tip of the iceberg, as you might guess. That is what the SEC agents knew. They knew about the improper markups but they also did not go in there under a subterfuge and I submit that this court says that, in fact, that it did. At least that is the charge and we may assume that they were guilty of that.

They went in under that subterfuge on the markups because they knew there was something shady in Denmark with regard to ESM and they were going after it.

I give your agents credit. I think they would have found it if we take the shackles off. Which means we give them the authority for oversight—somebody to protect the public in this instance.

Mr. **Goelzer**. I certainly agree with you that it is possible that we would have unraveled the whole problem, from looking at this particular problem. We have no way of knowing the answer to that.

The point that you keep making that I disagree with is that the staff member engaged in any sort of subterfuge.

Mr. **Luken**. Well, as I say, that is not central, not central to my point. We will concede that you disagree on that issue. OK. And move on.

Mr. **Goelzer**. The court never held that any subterfuge occurred.

Mr. **Luken**. All right.

Let me just pursue one other point. With regard to the capital adequacy ratio, this is a requirement of the Fed for the 36 primary dealers, right.

Mr. **Shad**. Yes; and also the guidelines provide that they not deal with people that do not meet the capital adequacy ratio.

Mr. **Luken**. But it doesn't apply to ESM because ESM is not one of the 36.

Mr. **Shad**. Yes; but it is very difficult for a nonprimary Government bond dealer to deal in the kind of numbers that were involved here without dealing with some of the primary bond dealers.

Mr. **Luken**. Let me suggest—there is still no enforcement SEC has the enforcement authority and so what SEC did in this case, finally, on March 4, was to come in upon complaint, or learning, it does not make any difference why. Things had come to a head. There was public discussion of the possibility of the problem with a repossession with ESM by this time, apparently, with regard to other S&L dealings.

I am just wondering what your role is, at this time. I am reminded of the old comment that you come in, after the battle is over, from the hills, and your main job at the present time is to shoot the wounded. That is about all we have got to do.

Mr. **Shad**. I would be delighted to give you a very brief account of what we did in this situation.

Mr. **Luken**. To be sure.

Mr. **Shad**. On March 1, which was a Friday, Mr. Thomas Tew, who is a local lawyer in Miami, was retained by ESM. He was brought in by one of their directors to do a review of their financials.

He worked over the weekend, became convinced that there was something like $250 or $300 million of assets missing.

The following Monday morning he met with the SEC's branch manager in Miami. By the afternoon, the SEC had granted authority to file an action in the district court and immediately did so. The defendants consented to a permanent injunction.

The problem of missing assets was brought to my attention by that Friday, by Mr. Lynch, the Acting Director of Enforcement.

In the first conversations with the manager in Miami, I wanted to know three things right away. How much. Whether there was fraud or what. And whether or not there was a $50 million bundle of securities that had been moved to Nassau or Switzerland where we could not really recover something quickly.

I immediately called Paul Volker to coordinate our efforts. They were already working on it from the New York Fed.

I spoke with Mike Wolensky then, who is here today and who is the regional administrator for Atlanta, to get him down there right away to get an overview as to, again, how much we are talking about. Is it fraud because it makes an enormous difference if it is purely trading losses, you know, bad business; or whether it is pure fraud. Which Mike immediately ascertained.

I got hold of the head——

Mr. LUKEN. Chairman Shad, if I could interrupt. I did ask about it but at the same time, as I have indicated it is not central to the point of prior regulation and I have gone over my time.

I wanted to bring up one more point. If you would like to submit in writing anything that you have not covered on this, the record will be held open for 90 days.

I just want to submit one other thing that you may comment about it if you so desire.

As we discussed, there have been a number of cities around the country that have had millions of dollars of losses because they were involved in this repo deals with ESM.

One of them has quoted Danny Crue, assistant city manager of Pompano. He says and I quote: "The thing that upsets us most is that we depend on the regulators."

Now, he may, as you suggest, be an improvident person and not a cautious person. But, at the same time, he expresses what, I think, many people out there are saying.

They assume, since other Government security dealers are regulated. I mean that other security dealers are regulated, the Government security dealers are regulated. Therefore, he is at least expressing the notion, the wish that these would have been, so that there would have been better oversight with reference to ESM.

I think his quote, the thing that upsets us most is that we depend on the regulators is, at least, pertinent to the discussion that we are having here.

Any comment. I have run out of time but I would be glad to give you the last word on it.

Mr. SHAD. I appreciate the statement. I am not going to argue with you. I would say that my predecessor gave a speech on the price of a riskless society where we try to regulate everything. It would be prohibitive.

If Mr. Crue and the others had properly collateralized, whether they are dealing with the best banking institution in the world or an unregulated Government bond dealer, if he had had any proper collateralization of his investment, it would have been forestalled.

Mr. **Luken**. I am going to bite my lip. I said I would give you the last word.

The gentleman from Ohio.

Mr. **Oxley**. Thank you, Mr. Chairman.

Chairman Shad, basically it is true that some of these sophisticated, or unsophisticated, or whatever investors made some very bad decisions. In some instances they really bought a pig in a poke. Isn't that a fact.

Mr. **Shad**. Yes.

Mr. **Oxley**. The fact also is, as you indicated, that in many cases, where they had an opportunity to have a hands on aspect to the securities, they chose not to do so, relied on somebody's word, and, at least at this point, are paying the price for that. Isn't that also a fact.

Mr. **Shad**. Yes, sir.

Mr. **Oxley**. And it is also a fact that, as much as we would like to try to regulate all of the human misbehavior that occurs, many times we just cannot imagine all of the ways that the criminal mind can develop to extricate money from our fellowman. Isn't that also true.

Mr. **Shad**. Especially a massive collusion between a number of parties: auditors, the company itself, and some of the S&L's that were providing excess margin.

That type of complicated effort is a very difficult one. All the regulation in the world will not necessarily ferret it out until there has been some harm done.

Mr. **Oxley**. You had mentioned, specifically, that you were working on the development of bank entry delivery systems. Could you give us a little more explanation as to how that would work and how close we are to that type of regulation, if you will.

Mr. **Shad**. It is already working. Our present effort—we are having workshops with the industry and other experts—is to accelerate the immobilization and, ideally, the elimination of paper securities through the use of central depositories and electronic book entry delivery systems.

If we can accelerate that, we are talking about billions of dollars of benefit and the prevention of these kind of problems.

Mr. **Oxley**. How long has the SEC been at work at developing that.

Mr. **Shad**. We approved in 1983 an expansion of the electronic book entry system for the institutions. This is for institutional investors, primarily in corporate, not in Government securities. We expanded that and the annual benefits, run around $350 million for the benefit of investors in the final analysis, just by going to book entry for the big institutional transactions.

Mr. **Oxley**. How do you describe benefits. What benefits, what tangible benefits.

Mr. SHAD. The difference between the manual movement of paper, engraved certificates, through the system and doing it instantly by safe and proven electronic communications systems that are book entry.

We are in a tonnage business today, with tons of securities being engraved and circulated into the system daily, coming out of the printing presses, plus the hundreds of millions of shares that are being transferred daily as transactions occur.

All of that could be reduced to a fraction of the cost by electronic systems and by eliminating this paper. We are being buried in paper.

Now, what we are doing right now, again, is trying to accelerate this process. There is really no problem technologically. I hasten to add progress has been made, since the paper crunch of the late 1960's and early 1970's in the securities industry.

The industry itself has succeeded in immobilizing about half of corporate stocks and bonds in central depositories. Once you get this into a room, you can make book entry in and out of that room without having to move this tonnage around the country, around the world.

Half of it is there. There are also other major segments that are not there yet, including the municipal bond market, mortgage-backed securities, and others. What we are trying to do is to accelerate this, which will reduce the risk of these kind of problems.

The other problem that is related here is that when you are doing short-term transactions, sometimes people are in and out of repos in the matter of 1 day, it is hard to get the paperwork, the physical delivery of a security back and forth within 1 day.

If it could be done by book entry, it would be much more efficient and effective to protect the parties that were buying these repos.

Mr. OXLEY. Had this system been on line before the incident occurred with ESM, could you safely predict that the problem that developed would not have developed, or that at least the appearance of fraud may have been uncovered earlier.

Mr. SHAD. I cannot predict that the people that have been hurt here would not have dealt with ESM as they did because we will not have full book entry systems for a long time.

The most dramatic news is that on February 22 the U.S. Treasury announced that starting next year all future Treasury notes and bonds will be on a book entry system, which is terrific precedent for us now to try to induce the private sector to follow that type of leadership.

Mr. OXLEY. Wouldn't it be prudent, in light of the recent developments, for people who are dealing in the securities business to either demand physical control of that security or at least the equivalent of the bank entry delivery system to be absolutely certain that they are dealing with a reputable outfit and that they do not get burned like we did with ESM.

Mr. SHAD. Yes; I do not like to suggest physical delivery because I think it may not even be practical for one thing. If you are in and out of a repo within 24 hours, you may not be able to. But book entry, yes, that is available here and now.

May I also say that after Lion Capital went down—some States said that their S&L's, and the State pension funds, could not deal in these repos.

The next thing you need is effective delivery, collateralization. One of the big reasons for so many people being hurt was the lack of collateralization. That is if they had collateralized their investments, it would not have happened.

Mr. **Oxley**. Thank you.

Mr. **Wirth**. Thank you very much, Mr. Oxley. I am sure that a lot of the people lined up in Cincinnati were saying: "Boy, I wish there was a collateralization here." I do not think they understood that.

Mr. **Shad**. That is not because of this. It was because of the failure of the largest S&L in Cincinnati.

Mr. **Wirth**. Let me point out before going to Mr. Swift that I think it is a bit disengenuous to suggest that what some of us on the subcommittee want to do is regulate all miscreant human behavior. That is not what we are talking about. Right.

Mr. **Shad**. I did not say that.

Mr. **Wirth**. Obviously, that is not the case. What we are talking about is just simply asking the question: Broker-dealers are regulated, municipal securities dealers are regulated; why aren't Government securities dealers regulated.

It seems to me that very simple question has come up in many many forms. We are not here for the purpose of saying: "We are going to try to regulate everything and its cousin." Let's be consistent, why aren't Government securities dealers treated the same as other dealers. We have been asking you about that for 14 months.

Mr. Swift.

Mr. **Swift**. Thank you Mr. Chairman.

Mr. **Dingell**. Mr. Chairman, could we have an answer to that question. I think your question is an excellent one and I am sure Mr. Shad might have some very enlightening comments. Could we ask him to respond to the question.

What is the difference, Mr. Shad, between a securities dealer who handles Government securities and a securities dealer who handles identical obligations from a private issuer.

Mr. **Shad**. No——

Mr. **Dingell**. They do exactly the same thing don't they.

Mr. **Shad**. No; they are not the same.

Mr. **Dingell**. What do they do that is different.

Mr. **Shad**. Ninety percent of the broker dealers that we directly regulate are dealing with the public, individual investors.

As to Government dealers, we use the term "dealer" but that includes almost every major corporation, bank, insurance company, and all kinds of different businesses that, in fact, are investing and trading in the trillions of dollars of Government securities outstanding. It is a professional-to-professional type of market as distinct from professional-to-individual investor.

Mr. **Dingell**. They do deal with the public, do they not.

Mr. **Shad**. ESM did not deal with the public as you and I define it; no.

Mr. **Dingell**. You regulate under your law at the SEC, dealers who deal from professional to professional. Do you not.

Mr. **Shad**. Yes, yes; but it is a byproduct of the——

Mr. **Dingell**. So then please explain why it is that, as matter of public policy, we do not regulate these people. You just had a collapse of the savings and loan system in Ohio because they were unregulated. Now why do we not go in and do something.

The situation drips fraud. It is described in the press as looting.

You seem to have a distinct allergy to entering into a dialog about how we are going to deal with this and prevent this kind of rascality in the future. I find that offensive.

Mr. **Shad**. We are working right now, and we have been for some time, with the Federal Reserve Board.

Mr. **Dingell**. Mr. Shad. Mr. Shad, your predecessor had an inquiry into ESM. Did he not.

Mr. **Shad**. Yes.

Mr. **Dingell**. And that was terminated by you, was it not.

Mr. **Shad**. No.

Mr. **Dingell**. Who terminated it.

Mr. **Shad**. Mr. General Counsel, who terminated it.

Mr. **Dingell**. The Commission terminated it. When I said you, I meant the Commission. You were there at the time that the vote took place, were you not. And were Chairman of the Commission.

Mr. **Shad**. I was there.

Mr. **Dingell**. And you voted in favor of it.

What was your position and who presented that issue to the Commission.

Mr. **Shad**. Mr. Goelzer.

Mr. **Goelzer**. I think the Division of Enforcement presented the recommendation.

Mr. **Dingell**. At who's behest.

Mr. **Goelzer**. Its own.

Mr. **Dingell**. Will you submit the books, records, and papers on that matter to this committee so we can find out who it was.

Mr. **Shad**. I think we had.

Mr. **Goelzer**. I believe you already have them, but, yes, we certainly would be happy to.

Mr. **Dingell**. Now let me just give you some history, and I am out of order, Mr. Chairman.

But I would observe, that in 1982 you had the Drysdale collapse. In 1982 you had the Lombard-Wall collapse. In 1982 you received letters and communications from this committee regarding those two failures. In 1984 the Lion Capital Group collapsed. In 1985 you have ESM Government Securities.

You act as if this were some kind of a surprising and extraordinary circumstance that had caught you completely unaware of the situation that exists.

The ripples which are expanding from this are causing untold hardship to local communities, to citizens, to States, and to other thrift institutions.

I think it is high time that you quit engaging in semantics and you look to a cooperative program in which you will participate, leading to effective regulation of this market so that further evil consequences of this kind do not obtain.

Thank you, Mr. Chairman.

Mr. **Shad.** I have difficulty in not accepting everything you said, Chairman Dingell, because that is what we are doing and we will continue to do it.

And a resolution was introduced by Mr. Rinaldo, in your absence. A 90-day period has been allowed for us to come back and—

Mr. **Dingell.** I am comforted by that, and I commend my colleague. I hope that during that 90 days, and at the very earliest portion of it, we will have some suggestions from your institution about the effective regulation of broker-dealers of this kind so that you are not dealing with it as fraud after the misfortune has occurred and so that you can treat these people through, at least, an intelligent self-regulation process of the same kind that you have when you deal with NASD and the exchanges.

Mr. **Shad.** And we have fraud in those cases and major scandals as well.

Mr. **Dingell.** Of course, but at least you have people in there looking at it.

Here, the whole matter came as a great surprise.

Mr. **Shad.** Well, it is still a very difficult area because, as, in your absence, Chairman Dingell, we did point out, we are dealing with the monetary and fiscal policy of the U.S. Government. It involves so much more than just the securities and exchange areas.

Mr. **Dingell.** These people, Mr. Shad, are not engaged in the making of monetary and fiscal policy. They are not the Treasury, they are not the Federal Reserve and they are not the 36 primary dealers. They are simply purveying the securities which are put together by persons who do engage in the making of monetary and fiscal policy.

There is a distinct difference between the the two events, the two kinds of behavior and the two kinds of persons.

Mr. **Shad.** And they include almost every major corporation, banks, and insurance companies. It is pervasive. We have this multitrillion market there, and it is essential to fund the national debt to have a very broad and liquid market—I do not know the parameters.

Mr. **Dingell.** Yes. It is also, Mr. Shad, essential to a liquid market and to the funding of the national debt that there be a measure of buyer confidence there.

I would point out to you that buyer confidence was severely shaken by these events and I am not talking about professional buyers who usually contrive to protect themselves very nicely.

By the way, I can read to you some of the things about how the operators of this corporation did—salaries of $400,000 and $500,000, $1.7 million payment to one who is deceased and it was called by persons who had observed it as "looting."

You seem to be quite anxious to sit there and say that this is some kind of a Government undertaking. Well, if it is a Government undertaking, then all I can say is God have mercy on us because that is the kind of Government we threw out in 1776 and we had better hurry and get them back out again.

Mr. **Shad.** Well I did not mean to suggest that at all. I think that it is an outrageous situation of fraud, conspiracy, and——

Mr. DINGELL. A fraud, you can only deal with after the event has occurred. I am telling you that you have a chance here to draft legislation so that you can participate in the prevention of fraud.

I think that is one of the things that you are there for. You are there to see to it that the disinfectant of sunlight functions for the protection of the public and not that this kind of knavery and rascality can go on unimpeded with bribery and other outrage affecting adversely the entire savings and loan system of the State of Ohio.

I suspect you had better rethink this matter with some care.

Mr. WIRTH. Thank you very much, Mr. Dingell.

I think as you talk, Mr. Shad, about monetary and fiscal policy being interwoven in this, some of us are concerned about is the regulatory policy being pursued. The SEC and much of this administration appears to be in a mad rush to the bottom. That is what we want to avoid and that is what, in part, this is about.

Mr. Swift.

Mr. SWIFT. Thank you, Mr. Chairman.

Just a comment on riskless society. There is nobody here asking for us to set up a riskless society. What we have had here is an event which has done all of the things that had been described this morning which have affected the value of the dollar on world markets, and which have affected the price of gold on world markets.

This is not some piddling little risk we are concerned with. I think that reference to anyone who is setting up a riskless society is inappropriate in the context of this hearing.

I would like to pursue two lines of questioning. One is generic, following a theme that we have had throughout this hearing. The other one is more specific.

You had made a point in your colloquy with the chairman's subcommittee, and it has been referred to a great deal, and I accept a large measure of its truth. This is an extraordinarily complicated problem.

That the SEC, and I think you used the analogy—of the blind men and the elephant. The SEC has a portion of this responsibility. The Fed has a portion. Other people may have portions.

But the fact is, we need to have a caucus of the blind men, a summit of those Federal agencies which have pieces of this action, to come together and formulate some means of dealing with this.

Now the subcommittee, and the whole purpose of the colloquy with Mr. Wirth, was that we were asking for some advice, and essentially your answer was, "Well we do not know enough about all of it to offer that kind of advice."

Well, Congress needs the expertise of administrative agencies to help formulate the policy. It is our responsibility to do it but we cannot do it in the dark.

If you do not have it all, I presume the Fed would tell us they do not have it all. Others could say they do not have it all and it makes it extremely difficult.

Now you have been given 90 days to come back with some information the gentleman from New Jersey requested. And you indicated that you might have to hold hearings and bring in some other people and consult with others who have the expertise the SEC does not have.

Might I suggest that that may be the summit. That may be an excellent opportunity for the SEC to be the initiating force that will bring together the various degrees of expertise necessary to make a recommendation to this committee.

I will tell you that I, as one member of this committee, would be happy to support an extension of that 90 days if there is a demonstration on the part of the SEC that you are undertaking that kind of comprehensive analysis. That you are playing the lead agency on trying to pull the various degrees of expertise necessary so that give us the kind of answers we need in a comprehensive fashion. It seems to me to be an excellent opportunity.

I think much of what you say about you having only a piece of the elephant is absolutely true. I think it is unfair to suggest that you somehow, fullblown, should have expertise that others may have.

But we cannot sit here and not get the complete picture and as long as we have started this ball rolling and you have indicated you need you need to call these other folks in. I would hope you would seize upon it as the opportunity to be the clearinghouse for Government expertise and you can get back to this committee with some well-rounded, fully based recommendations for the kind of action we could take.

Does that not seem reasonable to you Mr. Chairman.

Mr. SHAD. I would applaud you for your assessment of the problem and approach to it, and we will pursue it. I would like to ask the subcommittee a question which would be helpful in guiding us in that effort and that is the views of the subcommittee on functional regulation.

We have had essentially regulation by industry categories, so the Fed regulates some banks and the other banks are regulated by other banking agencies. The SEC regulates securities firms. The insurance regulators regulate insurance companies.

As a result of new products and services and this dramatic explosion of transactions through telecommunication technology, all of these lines have been crossed over now; and some are saying, well we ought to have regulation by functional activities regardless of whether or not Sears owns Dean Witter, or a bank is a bank and yet if it is engaged in broker-dealer activities, it should be subject to the same regulations as all other broker-dealers.

If functional regulation makes sense then a related question is: Within this functional area of the Government bond markets, should you have the Fed regulating a piece here and the SEC injected here and some other agencies elsewhere, the FDIC and the Federal Home Loan Bank Board.

We pulled in all of these agencies, incidentally, over a weekend to get into the ESM matter.

The question I am asking is, do you favor functional regulation and, if so, to what extent do you still just pick out pieces.

The SEC, I think, is—I wish somebody would join me in this—has done an outstanding job. As a consequence, we are often asked, well why don't you do it. You are doing a good job here, let's do it everywhere.

I really would like to see what the reaction is to whether we should just carve out this area and say, OK, SEC or somebody ought to go in there, or whether you want to go to a policy level of functional type of regulation.

Mr. **Swift**. The obvious answer to that, when you ask Congress anything, is some of us do and some of us do not. Probably you would have to discuss with individual members what they would like to see.

What I am suggesting is, that if we take at face value, your assertion that you only have a portion of this, I am willing to do that. I think there is merit to that.

And if we also take that from all the other agencies, at what point do you finally get together and massage this thing as a whole to help us. Because, that is what we have got to do. It seems to me that this may provide the opportunity to do that.

You see, I have the feeling that if we wait for this administration to convene that kind of a summit meeting, we will all be sitting here dripping with cobwebs.

Mr. **Shad**. Well, Mr. Swift——

Mr. **Swift**. They simply do not believe that you should regulate at all. I mean, they wander around talking about risk-free societies when that is not the issue.

Here we have an independent agency. You have to come up with some responses to this committee in this regard. You have already indicated you are going to have to go out and get some other expertise from other agencies.

It seems to me an excellent opportunity for you to take the lead and provide this committee with information and your points of view that are more comprehensive. So that we do not get the answer from each individual agency as they come by saying, "well we do not know enough about the whole thing to make a recommendation to you."

That is what you spend a year and 2 months, or the committee did trying to get an answer out of you. That was the answer. I accept the answer. Now you are in a situation to be able to do something more comprehensive about it and I hope you will take advantage of it.

As I say, I am dead serious. I will work very hard to get you an extension of time so that you can do that well on this committee if you show some demonstration that, in fact, you are taking it seriously and you are going to come up with some real answers for us.

Second point. This is more specific.

You have mentioned several times, about the need for investors to have collateralization. An expert quoted in a business newspaper article, states that for setting up collateral accounts for small investors—and they are talking about fairly good sized small investors—would cost about $1,000 to initially set it up and there would be charges for each transaction. This expert suggested that it would be impractical for an investor with less than $10 million to undergo that kind of a process.

Of the 27 local government investors at ESM, as of December 31, all but one were dealing with amounts of $15 million or less and 8 were investing less than $1 million. In other words, what this person is suggesting is that what you suggest as a solution is not something in which they could participate, practically.

Would it not be possible, and I think you almost refer to some of it in your testimony—perhaps you do, to provide a clearinghouse for these smaller investors in which you would be able to get the benefits of scale. A security depository, if you will, where the smaller investor would be able to get this collateralization at a cost that would not be prohibitive for them. Does that idea have any merit, as far as you are concerned.

Mr. SHAD. I think it does not.

I think that, as I mentioned, on February 22, the Treasury announced that starting next year they will not issue any certificates. They will get a completely certificateless electronic book entry system. Of course, there are a lot of securities already out there, this is only as to new Government securities being issued.

France has announced that within 3 years they are going to eliminate all existing securities and all new issues will be on the book entry basis. This is trying to get into the 20th century out of the 19th.

I would say it is a massive thing to try to set up. You are saying small investors; I mean people do buy savings bonds and other very small certificates. To set that sort of thing up is an enormous effort.

Mr. SWIFT. So you would agree that, first of all this kind of thing should go into Government securities, the electronic———

Mr. SHAD. Absolutely.

Mr. SWIFT. And, would you support a means, the SEC or the Federal Reserve or somebody could set kind of a custodian bank for the collateralization of Government securities, particularly for the smaller investors. Does that, handled in some fashion, does that make sense to you.

Mr. SHAD. I do not think that the central depository is the ultimate solution. I think the electronic book entry system is, and that is where the Treasury is going.

Mr. SWIFT. What is the cost. What about the county treasurer in Clallam County, WA; what is it going to cost him to be able to take his 10 million dollars' worth of securities that he had with ESM and be able to do this if it were, if the system prevailed.

Mr. SHAD. To do it by book entry would cost an insignificant fraction of what it would cost if it was done through certificates being shuffled around. It would be a fraction of the cost compared to what it takes now.

Mr. SWIFT. And maybe, maybe it is an unfair question but do you have any idea what that is. Is this $1,000 figure that I have got here to set it up and then a charge each time, is that not———

Mr. SHAD. I do not think that is realistic.

Mr. SWIFT. That would not be realistic for what you are talking about.

Mr. SHAD. Or even now, I do not think that it costs $1,000 to get physical delivery of the certificates. It is cumbersome, but I do not think you are talking about $1,000.

Mr. SWIFT. Without putting words in your mouth, then, in conclusion, Mr. Chairman; would it be fair to say, you have already said you think that Government securities should have this electronic mechanism and some means by which the smaller investor might be able to have a clearinghouse is not something you would object to, provided it couldn't be done directly through the electronic process.

Mr. **Shad**. Yes, could I mention a couple of the fundamental problems.

There are a number of States, 12 or 13 States, that have not as yet adopted the Uniform Commercial Code Amendments of 1977 which provide for the transfer and pledging of a certificate through electronic means. So you have the problem of 12 States.

You also have about 14 States that require insurance companies and others, municipal pension funds or State pension funds, to hold the securities within the State, in fact within designated trust companies and others. These laws ought to be eliminated in order to facilitate this thing we are talking about.

You also have the basic problem of changing custom and habits—the way people have been doing things for a long time. A lot of people want to have that piece of paper in their safety deposit box. And it is terribly expensive to accommodate that desire. But by and large the people that do are in their late sixties and as the transfers occur through gift or death, they go to the younger generation that are much more receptive to the convenience, the speed and the protection of electronic means.

They in effect would get the equivalent of a bank account. You know when people go to the bank, they do not get an engraved piece of paper; all they get is a bank book entry, and that is the idea.

Mr. **Swift**. Thank you, Mr. Chairman.

Mr. **Wirth**. Thank you very much, Mr. Swift.

Mrs. Collins.

Mrs. **Collins**. Thank you, Mr. Chairman.

Mr. Shad, I want to ask a related question before I get into my other questions. The futures in options industry operate out of my Chicago district.

Now that something is afoot in the government securities market, it ultimately has to impact on the futures and options being traded on those instruments, doesn't it.

Mr. **Shad**. Yes.

Mrs. **Collins**. So we could see even more ripples occurring beyond what happened with the S&L's in Ohio, couldn't we.

Mr. **Shad**. Yes, the financial structure of the country is interwoven, so a disruption in one place can spill into others as it has in this instance.

Mrs. **Collins**. Don't you find that a little bit disturbing.

Mr. **Shad**. Yes, I think that it would be desirable if we could avoid the interrelationships, but I do not think it is a practical possibility.

Mrs. **Collins**. Why don't you think it is a practical possibility.

Mr. **Shad**. ESM would be a good example. The consequences prove to be horrendous in part because the S&L's were not federally insured; they were State insured. And one, The Home State, had liabilities that it couldn't cover which were such that they would have exhausted the entire insurance fund for the State.

And the insurance fund has the right to call on these other S&L's, the other 70 out there, for additional contributions, but the conclusion was made early that they would not have been adequate, that it would have brought them down as well; and that caused the runs.

Somebody once said that "Democracy is terrible, it is just the best system available." And I think that you could say that about the financial system. There is no question that our system, with all of its complexity, is, by far, the most efficient and effective means of managing the interflow of capital throughout a large land mass.

Mrs. **Collins**. Let me ask someone else.

Commissioner Peters.

Ms. **Peters**. Yes.

Mrs. **Collins**. What do you think about the possibility of a dramatic shakeup in confidence in the futures and options market when something like this happens.

Ms. **Peters**. Well, I think I agree with the Chairman that there is such a possibility.

Mrs. **Collins**. And since there is such a possibility, what kind of assurance would the people, who either hedge in those markets or who are the speculators, have about what SEC is doing. What it has done in the past.

Ms. **Peters**. What our Commission is doing in terms of regulating the government securities area.

Mrs. **Collins**. Right.

Ms. **Peters**. Well, I happen to know that there are people out there, not necessarily only in the futures and options market, but just in the securities industry in general because I have been so told in the past couple of weeks that they would like to see more regulation in the governmental securities area.

There was not a suggestion that it should be us but probably an implication that since we are far more experienced in this area than, perhaps other agencies, that it would be good for us to take a look in trying to expand our power. They feel, if we are regulated, why shouldn't everyone else be.

But of course you know, well I will stop there.

Mrs. **Collins**. Of course, I know what.

Ms. **Peters**. Well, we have oversight over the options markets but futures is under yet another agency.

Mrs. **Collins**. Yes, sir.

Mr. **Marinaccio**. May I make a comment.

Mrs. **Collins**. Please.

Mr. **Marinaccio**. I agree with the point that you are making. I think that all the financial markets are interlinked and as a part of the interlinking of all the financial markets, the government securities market is a key part of the financial sector.

My question, and I think in my mind it is a very serious question, is if you go to a statutory-regulatory system, and that appears to be what the committee desires and I have no quarrel with it. I think you are going to have to make a basic decision as to who is going to run that statutory system.

I am not at all convinced that the SEC is the right agency of government to run that statutory system. When it comes to setting capital requirements for U.S. Government securities dealers, when it comes to setting position limits that these dealers may get involved in and so on; that seems to me has such a strong nexus to the Treasury Department's function of selling government securities and to the Federal Reserve's ability to conduct monetary policy in the open market that I think you may have to go to the Federal Reserve and the Treasury for a good part of that.

That is my concern. Is how to go about that. That would be my comment.

Mrs. COLLINS. Thank you. Commissioner Cox.

If the ESM failure were, indeed, an example of a pervasive fraud taking place by many characters and maybe beyond the detection of SEC, does that mean that SEC is now in a better position to detect fraud and irregularities of the type now being uncovered. And, to prevent similar situations in the future.

Mr. COX. Let me see that I understand the question correctly. Because of the ESM case, is the SEC in a better position to find fraud.

No, I do not think it is in better, it is not in worse position but the fact that it has been involved in this, I would extend my compliments to the work done by the staff so far but it has not somehow put the Commission in a better position to find fraud.

Mrs. COLLINS. Does it somehow make the SEC's antennas perk up a little bit more.

If for no other reason than the fact that Commission reports indicate potential frauds have increased dramatically with complaints up 94 percent in the last 5 years. Complaints received by NASD, are up 27 percent.

Wouldn't that tell you that somewhere, something is wrong and you need to be on the alert.

Mr. COX. I think that the Commission is ever vigilant as far as complaints and so forth. In response to your previous question——

Mrs. COLLINS. Well if it is ever vigilant, why hasn't it done anything.

Mr. COX. It investigates these complaints. I think that if you look at the enforcement record, it is outstanding with respect to any complaints about fraud.

Mrs. COLLINS. That leads me to another question. Do you think you have enough enforcement resources.

Mr. COX. Yes Ma'm, for the tasks that we undertake, I think that the enforcement division operates very well. I think that they are highly professional. They are thorough. It seems to me that they are adequately staffed.

Mrs. COLLINS. Let me ask the same question of the next commissioner.

Mr. TREADWAY. Treadway.

Mrs. COLLINS. Mr. Treadway. Thank you.

Mr. TREADWAY. The same two questions or just the last one.

Mrs. COLLINS. I think both are very good questions so you can hit both of them.

Mr. TREADWAY. The question whether ESM and the failure has made the Commission somehow more capable of dealing with fraud that involves the Government securities dealer.

I think the answer to that is no.

I think, though, that there was a question asked earlier that does bear on it. The question of, if ESM had been registered as a broker-dealer under the Securities Exchange Act of 1934, could there have been or would there have been, earlier detection which might have prevented what did occur.

I do not know, in that specific instance, that it would have, but if you look at what has happened with the Government dealers that have gone under in the past few years, all together—Drysdale, Lion, ESM—that some of that would have been detected, specifically Drysdale.

For example, Drysdale, the registered broker-dealer was known to be having net capital problems. It was known to the New York Stock Exchange, the SRO arising from its dealings in Government securities.

And the answer to that was to carve out the Government securities dealings and put them into a separate, unregulated entity so as to keep the regulated entity in compliance with the net capital requirements.

Now if that second entity had also been required to be registered, it would not have happened. It could not have been formed. It could not have gotten off the ground in the first place.

That is my response to how all that works.

The second one was, do we have enough——

Mrs. **Collins**. Enforcement resources.

Mr. **Treadway**. No.

Mrs. **Collins**. Why don't you have enough enforcement resources. Have you made application to, or talked to OMB about it.

Mr. **Treadway**. There are requests, as you know, submitted each year to OMB, and the Commission goes through the budgetary process, sometimes with success, sometimes with, not with total success, and sometimes not always getting the amount that an individual person on the Commission might think is the exact level for a given activity.

Mrs. **Collins**. Mr. Shad, I like this discussion about what has been asked of OMB. I understand that you asked for 12 additional positions in enforcement and in your budget submission, there was wording like this—and I quote,

> * * * The growth in the universe of potential violations may result in a more cursory evaluation of intelligence data associated with Matters under Inquiry. This may impair the staff's ability to effectively target matters suitable for formal investigation * * *
>
> With a growing universe of potential violations, the staff will have to exercise greater selectivity in opening investigations in order to target the program's resources to the most serious problem areas. * * *
>
> * * * with the growing numbers of matters warranting enforcement action, it will be essential that the cases chosen for prosecution involve more serious violations or have a greater deterrent impact in order to justify the use of limited resources. The maintenance of current staffing levels in the face of growing work load may also require greater reliance on the settlement of enforcement cases in order to avoid resource-intensive litigation. In some cases, this may mean the acceptance of limited relief. The increased emphasis placed on criminal prosecution as a deterrent to securities law violations will also strain the resources available to litigate the Commission's civil enforcement proceedings.

Now it is my understanding that OMB held the Commission to its current levels but, amazingly, this discussion I just quoted to you, which the Commission sent to OMB, was not submitted in the budget document you sent to Congress.

What I want to know is, who took it out. Mr. Shad.

Mr. **Shad**. This is the Executive Director of the Commission who——

Mr. **Collins**. Well, who took it out.

Mr. KUNDAHL. You are correct in saying that we asked the OMB for 12 more positions, but, during the course of the last several months, since that budget went to the Office of Management and Budget in September of last year, we have reprogrammed positions into the enforcement program and have met 5 of the 12 requirements that we cited to them.

So we did not feel that kind of language was necessary in the budget we submitted to Congress.

Mrs. COLLINS. So the Commission decided that you were going to delete the language, is that right.

Not OMB.

Mr. KUNDAHL. The budget we submitted to OMB had three levels of resources in it. The reference you are making is to the second level, our description of the current level of staff resources, but we had, as you know, other explanations for a reduced level or an enhanced level.

Mrs. COLLINS. So who took out the request for the 12. Did you take it out or did OMB take it out.

Mr. KUNDAHL. OMB did not give us additional staff resources——

Mrs. COLLINS. So OMB took it out.

Mr. KUNDAHL. That is correct.

Mrs. COLLINS. Did you ask them why. Or is their word gospel.

Mr. KUNDAHL. We appealed a portion of the cuts they made.

Mrs. COLLINS. And what happened.

Mr. KUNDAHL. We got restored most of what we appealed.

Mrs. COLLINS. But not those 12, or any part thereof.

Mr. KUNDAHL. That is correct. We did not appeal these 12 and so we did not get any of them restored.

Mrs. COLLINS. So you just accepted their word.

Mr. KUNDAHL. No, we reprogrammed from our own resources, 5 of the 12.

Mrs. COLLINS. But the answer is not quite the same.

OMB refused to give them to you. So then you said, "OK, we will go along without having them," and so you took from some other programs to cover the enforcement resources for an additional five people.

Right. Yes or no.

Mr. KUNDAHL. We did. Yes; we did reprogram.

Mrs. COLLINS. Do you need enforcement people today. Why can't you answer this question.

Mr. SHAD. Yes——

Mrs. COLLINS. Thank you very much, Commissioner, I appreciate that.

Now I yield back the balance of time to my chairman.

Mr. SHAD. Could I respond further to part of your statement.

Mrs. COLLINS. I don't have any more time, but I would like the Chair to allow me another 2 or 3 minutes. I am skeptical of what your answer might be because we haven't had any yes or no answers since we have been sitting here.

Mr. SHAD. Definitely, we could do more with more. There is no question about that.

Mr. COLLINS. Thank you very much. And I, again, yield back to the Chair.

Mr. **Shad**. I would also like to put the complaints that you referred to, in perspective.

We used to be on a manual basis. We have shifted to an electronic computer recording of complaints and for some periods of time experienced inconsistencies between the manual accounting for complaints and the electronic.

But in any case, you should, of course, bear in mind that despite 5 percent fewer people at the SEC, over the latest 4 years we have brought 57 percent more enforcement actions. The trend lines are going in the right direction to be responsive to the increasing complaints.

Mr. **Wirth**. Thank you Mrs. Collins.

Mr. Leland.

Mr. **Leland**. Thank you, Mr. Chairman.

Chairman Shad, as I noted in my opening remarks, I am very concerned about a proposal being considered by the New York Stock Exchange where one class of stock, would allow 10 votes per share, while another class may have just 1 vote per share or, perhaps, no vote at all.

Let me ask you, are you concerned over the possibility that the New York Stock Exchange may compromise its longstanding commitment to shareholder voting rights and the traditional relationship between corporations and shareholders by eliminating its one-share-one-vote requirement.

Mr. **Shad**. To answer you, that rule, if they decide to implement it—and they still have to go through their full board and make do some further efforts there—would be subject to the SEC's review.

So it hasn't done. The proposal would require two-thirds of each issuer's shareholders to agree to such a recapitalization to go to that level.

We have been reserving judgment on what the stock exchange is going to submit to us until we knew what it was. In other words, this is a preliminary proposal from a committee of the exchange.

Mr. **Leland**. I understand, Mr. Chairman, but can you please tell me what your opinion is on this.

Mr. **Shad**. I am very concerned over the erosion of shareholder voting rights, not only through the question of the stock exchange's rule revision, but through charter and bylaw amendments by corporations that impose super-majority requirements where a 10- to 20-percent minority can veto the desires of the majority.

I am concerned over the State statutes passed in the very recent past that do the same thing—afford a small group to veto, in effect, the desires or the opportunity of the majority.

The SEC has taken unprecedented action in Delaware in filing an Amicus brief questioning the chancery court's decision, involving the use of what are referred to as poison pills.

We did that extraordinary thing because we viewed this type of device as an almost absolute defense to tender offers and takes the investors out of the process. At least in the other forums, the shareholders do vote on these supermajority, other charter and bylaw amendments.

It is an area that is of definite concern to the SEC.

Mr. **Leland**. Let me ask the other Commissioners if, in fact, they are concerned also—a simple yes-or-no answer, would suffice.

Mr. **Treadway**. Would you give me 30 seconds more.

Mr. **Leland**. Certainly.

Mr. **Treadway**. I think the answer is, of course, yes. But I do not think you can answer yes or no in a vacuum.

Whether what the New York Stock Exchange is doing is right or wrong, I think you have to look at the forces that are driving the New York Stock Exchange to do that.

And that is the spate of hostile tender offers and the natural desire of companies to want to protect themselves and perhaps be in a position to ward off a takeover, maybe go to a white knight and get a higher price, if that is appropriate.

So to simply say that it is bad because this is occurring, I think you have to look at the pressure that is driving it and say, "Well, is there something bad there, also, that needs to be dealt with to keep it in balance."

Mr. **Leland**. But, if you recall, and I know it has been a long time since I have made that statement, but, in my opening statement, I referred to the fact that the Chairman has offered his leadership in dealing with the question of hostile takeovers and the whole gamut of acquisitions etc.

We are very concerned about that, but to clamor to do what we think the New York Stock Exchange might be proposing is a little scary to me.

As I get from you two, it might be the same for you. I know your concern now. We are very concerned about that but we also understand, to some extent, the gamut of the concern that we have before us.

Commissioner Cox.

Mr. Cox. Yes, Mr. Leland, I am concerned about any kind of recapitalization that may change the voting power. I think that, from the standpoint of investor protection, it is important that the shareholders of corporations have a large say in the policies of their corporations.

Mr. **Leland**. Commissioner.

Mr. **Marinaccio**. Congressman, I also need an extra 30 seconds. I am very concerned about recapitalization and other defensive techniques but, in my mind, they are defensive techniques and, I think, I probably disagree with other members of the Commission on this.

I think the culprits are some of the abuses in the takeover techniques that are driving managements to defend the interests of the corporation and their shareholders as they see it.

And I dissented from the Commission's filing of the brief in Delaware because I thought that the Commission should not get involved in a State court on purely a matter of State law when I thought the court was right on its reading of the business judgment rule.

So, I think, what this committee is doing, and Chairman Wirth ought to be commended, I think, for taking a fundamental look at what is going on in the takeover area. And, I think that it would be a mistake, in my judgment, to do something about the defensive techniques without also addressing the offensive technique side.

Mr. **Leland**. Don't you think that the New York Stock Exchange should, in fact, come to Congress and ask that we work together on this matter, as opposed to operating in a vacuum itself and trying to promulgate rules that would possibly do damage to the overall question of how we resolve the problem.

Mr. Marinaccio. In my own personal judgment, it is only the Congress that can set right the balance of all these things again.

Mr. Leland. Thank you very much.

Let me say before the next Commissioner says anything, and I do not say this to embarrass her at all.

But Commissioner Shad, Mr. Chairman, I would appreciate it if you would convey to the President that I really appreciate his wisdom in appointing a very brilliant woman, who happens to be a minority, to the Commission, because this is a rarity in this administration.

When, in fact, it is my opportunity to commend him, I would like to do so.

Mr. Shad. Thank you. Your sentiments are shared by all the Commissioners.

Mr. Leland. Thank you.

Commissioner Peters.

Ms. Peters. Thank you, Mr. Leland, I hope you continue to maintain those sentiments after you hear what I have to say.

Mr. Leland. There are people who happen to be brilliant adversaries, too.

Ms. Peters. Thank you, Mr. Leland.

I just want to associate myself with the remarks of Mr. Treadway and Mr. Marinaccio and distinguish my comment from one particular area.

That is the area of dual-structure capitalization in the first instance, as opposed to a recapitalization in the here and now, that would have some serious impact on existing shareholders voting rights.

I think it is important to emphasize that dual-structure capitalization has been around for quite a time and it is a subject of State law, and I am always a little leery about we in the Federal arena preempting existing State law. And, I do not necessarily think that a company is a terrible company because it may have that kind of capital structure.

There are a lot of them listed on the Amex and the over-the-counter market that are fine corporations that could not meet the listing standards of the New York Stock Exchange.

On the other hand, to the extent that the proposal, or any proposal, that comes to us from the New York Stock Exchange, would tend to take away, or restrict, or change existing rights of shareholders then, of course, I share the same concerns that my fellow commissioners and the Chairman share. I think that any such proposal would have to be carefully scrutinized and examined.

But I do, if I may, disagree with you in that I do not think it is the New York Stock Exchange trying to change the world. I think they are trying to respond to competitive pressures and we have to take that into consideration as well.

Mr. Leland. Well, let me correct you to some extent.

I do not necessarily think that they are trying to change the world, I just think that we need to look further into the matter.

Ms. Peters. And I agree with that.

Mr. **Leland**. The Congress must take some kind of action because we are very much concerned; not only because of what it does to shareholders but also in terms of the movement of huge amounts of moneys that, to some extent, dry up the marketplace from the small- and moderate-business interests, as well as individuals too.

We are concerned about all of these matters. I think we have to take a comprehensive approach and what we are afraid of is that the New York Stock Exchange just might react or respond, if you will, too hurriedly and without careful consideration about the nuances that exist in the other part of the world.

Chairman Shad, what would be the consequence for the proxy process of adoption of this proposal by the New York Stock Exchange.

Mr. **Shad**. In order for a company to recapitalize, to provide two classes of stock with one having as little as 1 vote where the other would have 10, their proposal would require shareholder approval by two-thirds of the shareholders. So they would have to put it into the proxy and let all the shareholders vote on it.

Mr. **Leland**. Do you believe that the exchange's proposal has resulted from the competitive pressure generated by other less-regulated markets including, in particular, the over-the-counter market.

Mr. **Shad**. Some companies have been willing to delist in order to go to the over-the-counter market, in order to—I do not want to analyze their motivations—but by doing so, it has permitted them to have so-called A–B capitalizations.

Mr. **Leland**. Would shareholders be better served if, rather than the New York Stock Exchange moving forward with this proposal, these other markets were required to adopt standards to protect shareholder voting rights, which are equivalent to those presently in place at the New York Stock Exchange.

Mr. **Shad**. We have had direct conversations with the chairmen and presidents of the New York, and the American, and the NASD, as well as meetings with the advisory committee of the NASD and the board of directors to the NASD on the corporate governous areas.

Now these rules, by and large, are within their authority under our oversight.

To answer your question, specifically, the concern has been over competition to the bottom of the barrel by the exchanges and the NASD.

The NASD has recently taken a very constructive move, on the recommendation of their advisory committee, to require a certain number of independent directors plus committees with independent directors reviewing those companies. So it is a notable movement by the NASD to come up to the higher levels that obtain on the exchanges.

Mr. **Leland**. So the Securities Exchange Act and the Commission's own rules provide it with sufficient authority to reject the New York Stock Exchange's proposal. Assuming that the New York Stock Exchange eventually submits it to you for your approval and the Commission were, in fact, inclined to reject it.

Mr. **Shad**. Yes, yes; I would say to your question, we would have the authority to reject.

Mr. **Leland**. Do you think it is an appropriate congressional role in evaluating the New York Stock Exchange's proposal. Do you think we are needed here in this whole issue.

Mr. **Shad**. Well, I think it is a very broad area that includes that question and I commend, as you have, Chairman Wirth, on the efforts of this committee.

This whole broad subject, it is all interrelated—certainly to the concerns that have been expressed by Commissioner Marinaccio and others over the reaction of industry to this dramatic increase in tender offers. And this is one of the byproducts of that overall development.

Mr. **Leland**. Let me ask you something about our involvement as a subcommittee and as an instrument of Congress.

Are you excited about working with us on these matters.

Mr. **Shad**. I like the idea of working with you on these matters.

I think that sometimes it becomes more adversarial than, you know, is necessarily helpful. It is important to try to ventilate and join forces to respond, to perceive problems.

Mr. **Leland**. I appreciate that and I look forward to working with you.

Mr. Chairman, I have several other questions and I am willing to forgo lunch if you are, to proceed on these matters.

Mr. **Wirth**. I thank the gentlemen.

I have a couple of specifics related to the budget and then we will come back, if the gentlemen would like. Thank you very much.

Thank you, Mr. Leland.

Before getting to the budget questions, however, let me review very briefly with the Commissioners, the question of legislation related to tender offers.

As you remember, last year the Commission sent up to the Congress its bill called the Tender Offer Reform Act. As you will remember the bill had five provisions in it.

One was designed to regulate bidders by closing the so-called 10-day window for reporting acquisitions of 5 percent of a company's securities under section 13(d) of Exchange Act.

And it had four provisions limiting the kinds of things management can do to defend against tender offers. First, limiting golden parachutes; second, limiting greenmail; third, preventing a company from issuing stock as a defensive move; and fourth, preventing a company from buying back its own stock as a defensive move in a tender offer.

You are all, I am sure, familiar with that bill. Let me ask each of you whether you believe that legislation tilted the the playing field in favor of the bidder, or the target, or was it a neutral piece of legislation.

Let me start, if I might with you, Commissioner Peters.

Ms. **Peters**. Yes, Mr. Chairman. It is my view that that piece of legislation, with the exception of the proposal to close the 10-day window in 13-D, tilted the playing field toward the bidder. I——

Mr. **Wirth**. On balance.

Ms. **Peters**. On balance, I thought that it tilted the playing field toward the bidder and, had I been here, I probably would—I suspect I would not have have supported it, except, with the exception that I mention, which, I think, is something that I would like to see done.

Mr. **Wirth**. Mr. Marinaccio.

Mr. **Marinaccio**. I, too, think that that legislation tilted the field in favor of the bidder and I think I would have tried to argue to get a little bit more on the other side before I would have supported the legislation, had I been there.

Mr. **Wirth**. Commissioner Cox.

Mr. **Cox**. For the parts that you spelled out—the 10-day window and the golden parachute, greenmail, stock issue, and self-tender offer—I think that in the scheme of tender offer regulation they fit in a neutral way.

Mr. **Wirth**. When you say, in the parts that I spelled out; were there other parts in the legislation that was sent up from the Commission.

Mr. **Cox**. Oh, from the Commission. I am sorry. I misunderstood what you said.

Mr. **Wirth**. This is the Commission's bill. We are talking only about the Commission's bill.

Mr. **Cox**. OK. Then my comment stands just as stated. I misunderstood.

Mr. **Wirth**. So your position is that it was neutral, right.

Mr. **Cox**. Yes.

Mr. **Wirth**. Mr. Treadway.

Mr. **Treadway**. It tilted it more in favor of the bidder.

Mr. **Wirth**. And Chairman Shad.

Mr. **Shad**. Well, I think that Commissioner Cox has made a valid point. If you take the entire package, which included closing the 10-day window, and if you also take the finely crafted words used to try to carve out certain defensive tactics by bidders in the heat of battle, which is the way it was set up, I would say that on balance it may have tilted it slightly toward the bidder. But I think it is pretty neutral.

In other words, on the 10-day window situation—we have had companies, or bidders, accumulate as much as 34 percent between the time they got across the 5-percent threshold and 10 days later, when they make public disclosure. And, in effect, was a big advantage for bidders.

Closing the 10-day window limited that opportunity. On the other hand, again, we have made it clear that the things you have alluded to would only be proscribed in valid tender offers.

And it went beyond that to define what a valid tender offer was. So that the bidder could not use these new provisions to block General Motors from doing a financing or a legitimate reacquisition program.

It would only be during a tender offer, and it would only be if the bidder was prepared to make an unconditional offer for at least 10 percent of the stock up at least 25 percent.

Now, that is a pretty heavy standard for a bidder to satisfy. Very, very few, if any, tender offers are unconditional.

Mr. **Wirth**. OK. So if I count properly, Ms. Peters thought it tilted toward the bidder; Mr. Marinaccio, toward the bidder; Mr. Cox, neutral; Mr. Treadway, toward the bidder; and Chairman Shad, slightly tilted toward the bidder but essentially neutral. Which would suggest that there would be a 3-to-2 vote against that piece of legislation this year.

Mr. **Shad**. Well there might be a refinement of it as the result of the full Commission——

Mr. **Wirth**. I know that. I gather that that is the case.

The logical followup, then, is, are you all working on recommendations for the Congress in the area of tender offer reform in 1985.

Mr. **Shad**. Could I respond. There have been also changes in the marketplace since that legislation was sent up, not the least of which has created——

Mr. **Wirth**. Chairman Shad, you are wonderful. You know, if you were a Member of Congress when you go over to vote, there is a "No" button and a "Yes" button. There is no "Maybe" button. Go ahead.

Mr. **Shad**. The greenmail process for instance—some companies have amended their charter and bylaws to prohibit them from paying greenmail. So the public sector is reacting to this.

In addition——

Mr. **Wirth**. The public sector is reacting. There is no question about that. There is a lot of public reaction out there.

Mr. **Shad**. And it has taken new forms.

Instead of it being a very simple transaction where the bidder is accumulating a large block of stock and gets paid a significant premium for that block, you now see situations where they are swapping stock for assets, or for a subsidiary, or doing other things. So that, it is a different situation.

And, as is so often the case, we identify a problem, we come up with a response to it, but the market is so quick to figure out other ways to let the supply and demand factors prevail, that we cannot always hedge it in, if you want to call it that.

Mr. **Wirth**. Let me ask the question again then. Are you working on recommendations this year for legislation in the area of tender offer reform. Or, should we do nothing.

Mr. **Shad**. Well, we anticipate testifying and, in preparation for that, the Commission will form its views and submit them to you in formal form as well as orally, in the testimony.

Mr. **Wirth**. When will we have recommendations from you.

Mr. **Shad**. I am not sure. You have already established that the present Commission is going to change very shortly because of two people leaving the Commission. Until we have a full complement——

Mr. **Wirth**. They are both no votes on this bill, too.

Mr. **Shad**. Until we have a full opportunity of the byplay between Commissioners and the issues being fairly accurately defined and everybody having an opportunity to respond, I cannot predict——

Mr. **Wirth**. Mr. Treadway, let me ask you. Should the Commission be meeting and sending us recommendations on changes in the law related to tender offers.

Mr. **Treadway**. Well, I guess since I was the loser on this 2-to-1 vote in this area when the package was sent over, I would say yes I would have liked for that to have occurred. But it is, I think practically speaking, it would have been difficult so shortly following the submission of the legislative package.

They took a position to immediately convene meetings when the other two Commissioners came aboard and suddenly——

Mr. WIRTH. I am looking prospectively now, from where we are now for 1985.

Mr. TREADWAY. Prospectively, I think, in the long run, yes, the Commission should be formulating some proposals.

Mr. WIRTH. Do you think you should be doing that, Commissioner Cox.

Mr. COX. Yes; I think we should be vigilant. We should be taking account of the hearings that you are conducting and the information that is coming to light on just what is going on in the tender offer market.

Mr. WIRTH. OK. That is not the question, whether you should be vigilant or whether you should be aware of the hearings. The question is should the members of the Commission be meeting to formulate and send us recommendations related to reform in the law related to tender offers.

Mr. COX. Yes; to the extent that from information and our vigilance, we find areas that should be worked on, yes; we should be doing that.

Mr. WIRTH. Mr. Marinaccio.

Mr. MARINACCIO. The answer I would give is yes and I think that the best opportunity for that would be an invitation to testify before your Committee. And that would be a way to focus the Commission on a specific piece of legislation.

Mr. WIRTH. Without objection, Mr. Marinaccio, you can assume that that invitation will be forthcoming and we look forward to the consensus Commission position on the subject of tender offer reform.

Ms. Peters.

Ms. PETERS. I am glad you like to anticipate concensus, Mr. Chairman.

Yes; I think the Commission has taken, already, its first step toward trying to come to some determination on recommendations.

In this area, under Chairman Shad's leadership, we conducted an economic forum last month, which I think was helpful to us all in exploring these issues. I am sure that we will take the comments here, this morning, as an invitation for us to meet and discuss the issues further, sooner, rather than later.

Mr. WIRTH. For one so new, Commissioner Peters, you are really a good witness.

Let me ask some specifics on the budget. But before doing so, I ask Mr. Leland if you have other questions you wanted to ask.

Mr. LELAND. I do, indeed, Mr. Chairman. Thank you.

Chairman Shad, on December 4, 1984, when Mesa Petroleum announced its bid for Phillips; 1,637,900 shares of Phillips were traded.

The following day, trading in Phillips jumped to approximately 7.6 million shares, or 5 percent of the total outstanding shares. During the entire month of December, trading volume was over 43 million shares, or 28 percent of Phillips shares.

Trading for December through February represented a turnover, equivalent to almost 94 percent of Phillips total of 150 million shares.

Does the Commission know who is trading this enormous volume of shares.

Ms. **Peters**. Excuse me, Mr. Luken, while our Chairman digests that question. I am sorry Mr. Leland.

Mr. **Leland**. That is all right.

Ms. **Peters**. I am sorry.

Mr. **Leland**. We might look alike but we do not have the same accent.

Ms. **Peters**. And you are from Texas, I remember that.

May I be excused, Mr. Chairman.

Mr. **Wirth**. Please.

Ms. **Peters**. Thank you.

Mr. **Shad**. I would say yes. We know in broad numbers. I could not get down to identifying specific persons.

There is a lot of turnover between the same people, back and forth, and so it is not just the one-time sale of an enormous percentage of a company's shares from one group to another but within the group, there is churning.

By and large, it was a movement from institutions and individuals to arbitrageurs who were willing to assume the risk that the deal would go through on an attractive basis. They provide a service in doing so.

It is a movement from institutions and individuals to arbitrageurs who are professional risk assumers and sometimes they get badly hurt, of course.

Mr. **Leland**. What happens to long-term shareholders in a takeover battle like this.

Mr. **Shad**. The tendency is to accept the opportunity to realize a very substantial profit or premium over the prior market price. And they have the problem of saying if I do not go along with this, if I dissent, I oppose it—in the case of Phillips, how long would it take the company through its normal growth and development to equal what I can get tomorrow because somebody is willing to pay me a big premium for my stock.

Mr. **Leland**. We are told that once a takeover is announced, the shareholder community shifts dramatically and much of the target company's stock shifts to the hands of short-term speculators. What does the Commission know about this.

Mr. **Shad**. We are very familiar with the process. Could you be more specific.

We know that, as I have just said, that the arbitrageurs provide this opportunity for people that want to take advantage of it with the certainty of today's price versus the uncertainty of whether or not the transaction will be consummated.

Mr. **Leland**. Articles in Business Week identify a large role-play by arbitrageurs in the Phillips trading. Business Week says that many arbitrageurs are disenchanted with Pickens after they loaded up on Phillips shares when Pickens pledged that he would not sell unless other holders were paid equally for theirs; so disenchanted, in fact, that they are threatening not to support him when he launches his next hostile takeover. Do you know how large a position arbitrageurs held during the Phillips battle.

Mr. **Shad**. I would like to ask Cathy McCoy or somebody in Corporation Finance, who might be able to give you the specific number, but it was a very large percentage of the outstanding stock.

Ms. McCoy. Congressman Leland, I do not have that number with me and I am not sure that it is something we can get for you. If we can, we will have to supply it for the record.

Mr. Leland. I would appreciate a response from you if, in fact, you can respond.

Ms. McCoy. We know. This is Joseph Connolly, the Chief of the Office of Tender Offers.

Mr. Connolly. Your question was——

Mr. Leland. If you would speak into the mike, I think it would be helpful to the recorder.

Mr. Connolly. Your question is the number and the percentage of shares owned by arbitrageurs during this time. Is that your question.

Mr. Leland. Yes.

Mr. Connolly. We have no way of knowing the specific number of shares that the arbitrage community generated or acquired during that period of time. Under the Commission's beneficial ownership reporting provisions, once a person acquires more than 5 percent ownership, they must file their schedule 13-D within 10 days.

I can tell you that we did not receive any 13-D's during this time from persons other than the Mesa Petroleum Group. If the beneficial ownership provisions were being complied with, no particular arbitrageur acquired more than 5 percent to require the beneficial ownership report to be filed.

Now, we were advised that Phillips Petroleum was controlled by approximately 48 percent of their stock by institutional investors. So there was a tremendous institutional investor holding of this security, and many of those shares were trading hands.

You mentioned the large percentage of trades during that period of December. A large portion of these trades, we anticipate, was just the same shares changing hands.

It was not all shareholders, 94 percent of the shareholders changing their economic interests but rather these various arbitrageurs, who were following the market news very closely were, either, taking positions, or, unloading those positions within a relatively short period of time.

But the specific answer to your question is, we do not have that information.

Mr. Leland. Well, can you get the information. We would like to know who. And, we would like a full comprehensive report on this matter.

Mr. Shad. When we get to 13-D, we can give you that. But, as they just said, no arbitrageur had as much as 5 percent so it is an awfully difficult thing to determine—we cannot do much more than——

Mr. Leland. Mr. Chairman, I realize that it is difficult but it is not impossible. We would like, very much, for you to give us all of the information, if it is humanly possible.

We understand the complicated nature of the problem. But, we would like, very much, for you to give us a comprehensive and, as close to, a total response as you can.

This matter is so serious that it would be very helpful to us. If, you can assist us in this matter, we would appreciate it.

Let me ask you while you are still here, maybe you can answer this question. Mr. Chairman, maybe you will be able to answer too.

Do you know how much exchange of information took place among the arbitrageurs and other big investors during the Phillips takeover battle.

Mr. CONNOLLY. We have no idea. What communications——

Mr. SHAD. All the communication that was public, of course, was carefully monitored by the Corporation Finance Division.

Mr. LELAND. The Commission's job is to protect shareholders or stockholders and it has rules to do so.

Recent articles indicate that the controlling shareholders in a takeover attempt, like the Phillips case, are the arbitrageurs. Does the Commission know who the big players really are. That is what we are trying to arrive at. We are trying to get to who the real big players are.

Mr. SHAD. We know that the institutions, as has just been stated, owned 48 percent. A lot of that was sold to arbitrageurs, as well as a lot of the other 52 percent was sold to the arbitrageurs.

Mr. LELAND. Mr. Chairman, we would appreciate—I understand and I appreciate your response in the limited manner that you can respond today.

I would appreciate, as I have suggested, that you respond, however, after whatever time you might deem necessary. Hopefully, it is——

Mr. SHAD. Are you suggesting that we poll the arbitrageurs and find out what they actually tendered at the——

Mr. LELAND. Exactly.

Mr. WIRTH. If the gentleman would yield.

I think the issue is that if the arbitrageurs get together, in some fashion, can they control whether or not an offer is going to be successful.

Is that the potential out there and should we be concerned about it. Is that a possibility.

Mr. SHAD. If they did that, they would be in violation of the section 13-D requirements and, in fact, it is a keenly competitive area, where they are in competition with each other. Each one is trying to get an advantage out of the market rather than share information with each other.

If there was collusion of any sort, if they formed a group in any way, they would come within the 13-D requirements, to report—if they ended up with over 5 percent, to make that disclosure.

We have no evidence. These are the kind of things we very carefully monitor, and we are sensitive to, and we do not have any evidence of collusion among the arbitrageurs.

Mr. WIRTH. Mr. Treadway, you——

Mr. TREADWAY. No, I think that that was the point that I was going to make.

I think studies show that by the time a tender offer is actually, you get to the final tendering stage that the majority or the vast majority, perhaps, of shares are tendered by arbitrageurs.

But, so—to answer your question, do the arbitrageurs, in a sense, control whether the deal goes through.

Yes.

But whether they are acting in concert with each other as an organized group, as opposed to just in parallel fashion, it is a different issue.

Mr. **Leland**. Mr. Chairman, I have no more questions.

Mr. **Wirth**. Thank you, we would appreciate your best analysis of that.

Again, the purpose of this, our purpose and your purpose, is to protect shareholders. Is there some way in which shareholders are not being protected by some mechanisms in the market. The better information that we have, the better off we are going to be.

Let me, if I might, ask you some questions, specifically, about the budget, Mr. Chairman, and preface that by noting the two themes you and I have discussed over the years.

One, this is a rapidly changing and very, very complicated marketplace. We all agree with that. Your job is enormously difficult. We understand that. I think everybody on the subcommittee is committed to providing the resources necessary to the SEC to do the job in this very complicated world.

As you know, the SEC collects fees, which exceed the cost of running the agency. Most of us believe that it is worthwhile for the Commission to make the investments necessary to keep that marketplace safe and secure. Those are very, very tiny investments for an enormously large return to society, which is why these capital markets are as good as they have been.

So, given the pay-as-you-go nature of the SEC, we are concerned that all of the necessary investments be made.

Given that, and given the fact that we do want you to have a budget that will provide you with the necessary resources, I would like to ask you a couple of questions about your submission.

In your budget submission 2 years ago, you noted that in 1982, the SEC had reviewed 14.7 percent of all the annual reports filed by companies with the Commission. At that time, you called this a barely adequate presence to provide a strong deterrent to fraudulent disclosure.

Last year, according to your budget submission, the Commission reviewed only 13.7 percent of all annual reports. In other words, a 1-percent drop. But, you added that you had hoped that your numbers would be up to 20 percent.

How do you determine what an adequate review is. Is it 10 percent, 15 percent, 20 percent, 25 percent. How do you make that kind of a judgment as to what ought to be done.

Mr. **Shad**. We are constantly trying to improve our selective review criteria in order to identify those filings which are the most likely to pose regulatory questions to be responded to by the issuer.

It was 14 percent of the 10-K's, I believe for the fiscal year ended in September—not 13 percent—up from 12 percent the year before. And, in addition, we reviewed, in part, 32 percent of those filings.

But we are steadily trying to improve the effectiveness, the cost effectiveness, of our review process by refining our criteria. I would say that 14 percent, if it was just a random selection, would still be a large percentage for a random review. But it is not a random review. There are a whole lot of very specific things that trigger the review.

Mr. Wirth. You have always said, "one of the good things is that we have this selective review program" and that you put a lot of reliance on that. But, when we went through a lot of the budget drill in 1983, as I remember it, Commissioner Longstreth joined Commissioner Treadway in reviewing selective review and they said as follows:

> Selective review is based on three factors; qualified audit opinion, enforcement actions, and troubled company. This leaves out companies that may be on the verge of problems. The current selection process kicks out companies only after they are known to be problems.

That would suggest to me that maybe we ought to go back again and look at the question of how many——

Mr. Shad. That is not true today.

Mr. Wirth [continuing]. How many of the annual reports you are looking at.

Let me ask Mr. Treadway who is one of the authors of that 1983 study. Are we currently, reviewing enough of the 10-K's? How do we know how many should be reviewed.

If I were a CEO and knew that it was 1 in 6, which is about what it is now, and the average tenure of a CEO in this country, I think is a little less than 6 years; he might say well, the chances are that I am going to get through my whole tenure without an SEC review. I think those are approximately the numbers.

What is your answer to that, Mr. Treadway.

Mr. Treadway. Well, I think it—coming to a specific percentage is always going to be difficult and there will be room for reasonable people to disagree.

My personal view, I have not gone back and looked in detail this year at the selective review and the criteria that are being used now, as I did last year.

But, I have felt for a long period of time that the right level of a 10-K review, not selective but full, is somewhere between 25 to 30 percent with an additional ability to do a random, an additional random sampling to pick out another, say, 5 percent or so.

That way a company knows that the chances of full review when they go file are 1 out of 3. Management is there, traditionally, through that period of time so that they know that they will be subjected to this review.

Financial information in the 10-K, by and large, is 3 years of information. And I think that since the fact that the 10-K is the most important disclosure document in the entire system, that that type of discipline is good preventive discipline and, this is anecdotal, but in talking to people in the business and on the street, members of the investment banking community, who do the underwritings for companies; they say, yes, we think companies ought to be reviewed fully once every 3, 4 years—from the people I have spoken to.

Mr. Wirth. So you would suggest, based on your experience at the Commission, that there ought to be about double the amount of review that is going on now.

Mr. Treadway. That is about right.

Mr. Wirth. Now, let me argue the other side of it.

In the budget document submitted to us by the SEC, it was pointed out last year, that the disclosure review had resulted in 180 cases being submitted to the enforcement division of the SEC. And this last year, the number submitted to the enforcement division had dropped by 50 percent—about 90 cases. 180 dropped down to 90.

Which could be argued to suggest that disclosure was very good. In fact, was getting better since fewer cases were referred to the enforcement division.

Mr. Treadway. Well, if you wish to argue that——

Mr. Wirth. I am asking you. Is that adequate—If I were David Stockman, I would say, "cut the budget." "Everybody is doing a better job."

Mr. Treadway. I would not accept the logic of that argument because what about the cases that we do not know are going to come out in the next 2 or 3 years when the filings were being made that, maybe, were not worth review. Still, I question that if you did not have the stop sign there, how many accidents would occur. It is almost an unknown.

My reaction to the 10-K review issue is that if you are talking about, let's use some worse numbers—a 10, 11 percent; 1 every 10 years. Since you are missing so much of the universe, it seems to me that you really ought to take it down to probably just the bare minimum, the ones where there are known problems and do away with it and say, "Sure, you are on your own and you will get sued after the fact if there are problems."

But if you are going to have a meaningful presence that is known to the issuer community, I do think you have got to get it up to around the 30, 35 percent level.

Mr. Wirth. Well, I could argue we are doing less of a good job reviewing the 10-K's and that is why fewer cases have been sent to the enforcement division. You can do that both ways.

Mr. Cox.

Mr. Cox. I do not have a specific number. I would say that the 20 percent would be a reasonable goal. I would not quarrel with Commissioner Treadway's request for 30 percent.

As far as the quality of the review, I think that it has been consistently high. I know that the staff has made a real effort to maintain that quality while balancing off with review of initial filings and so forth. I would not interpret it as a poorer review resulting in fewer cases.

Mr. Wirth. Commissioner Marinaccio.

Mr. Marinaccio. Congressman, I really do not have anything to add to what Commissioner's Treadway and Cox have said. But, it was my understanding, you may ask George this, down at the other end; my understanding was we were going to, this year, beef up substantially the full disclosure aspect of the Commission's work to meet some of the problems that you have indicated are out there.

Perhaps, George might want to speak up a little bit on how exactly we have provided, in the budget for doing that.

Mr. Wirth. Let me just see if I understand, before we get to that question——

Mr. Marinaccio. The number I have heard——

Mr. Wirth. At least three of you are suggesting that the level of 13, 14 percent is not adequate. That we ought to be going to 20 or 25 or maybe 30.

Mr. **Marinaccio**. I would say 20——

Mr. **Wirth**. How many people would it take to do that.

Mr. **Kundahl**. I cannot tell you off the top of my head, but I would like to respond to Commissioner Marinaccio's point by reminding you that, you know, we are going from 14 percent to 20 percent in the fiscal 1986 budget we have submitted. Over the period from fiscal 1984 to 1986, we have added 45 people to the full disclosure function. Admittedly, a large number of those people are involved in the Edgar Project. The Edgar project will enable us to do better reviews and more reviews more quickly. So we would like to think that we are making an investment now that a couple of years downstream will enable us to get to the levels that you and Commissioner——

Mr. **Wirth**. So you are convinced that the addition of 45 people, this year, will get you to a 20-percent level in 1986.

Mr. **Kundahl**. No. I was pointing out the difference between 1984 and 1986, and, over that period, we have added 45 people. And I am saying, it is a combination of Edgar and more review, but I think we are moving in the right direction.

Mr. **Shad**. It is about half more review and half Edgar.

Mr. **Wirth**. Are you convinced that you have the resources and that when you come back next year it will be 1986, that you will be at 20 percent.

Mr. **Kundahl**. Our budget would provide for that.

Mr. **Shad**. It is the function of a lot of things, of course, in terms of the activity in the market. And the review includes a large percentage, a very large percentage, of initial public offerings. And that is one of the most difficult areas to predict.

If we do not promptly review those initial public offerings, it adds a lot of cost to the whole system in terms of access to the marketplace by those issuers.

We reviewed, this past year, 78 percent of the initial public offerings. And so, that is part of the reason—the volume of public offerings of functioning markets, as the market goes up, you have got more.

And so, we are in the difficult area of trying to gauge what sort of demands will be put on the corporation finance division in terms of public offerings of securities, as well as the 10-K's, which are filed by all 10,000 publicly owned companies.

Mr. **Wirth**. For the purpose of increasing the examination of disclosure, did you rob other areas of the budget. Let me specifically point to one area where there is an enormous increase in activity which relates to the monitoring of broker-dealers.

Mr. **Shad**. Well, I do not think of it as "robbed" but——

Mr. **Wirth**. Borrowed.

Mr. **Kundahl**. We did reprogram people from the——

Mr. **Wirth**. Reprogram.

Mr. **Kundahl** [continuing]. Securities market regulation program to full disclosure. In our opinion, the assets were more important to us in full disclosure.

Mr. **Shad**. And also, we have consolidated, within the NASD, some 600 over-the-counter firms under their direct supervision that we had to inspect before.

Mr. **Wirth**. Is your examination of broker-dealers adequate.

Mr. SHAD. You know, again, if you do more, you get more.

But, I think, the incremental rate of return on more would not be as great as we are getting now. I think to add more people to the job would not proportionately increase the benefits of the effort.

Mr. WIRTH. You say approximately 6 percent of all broker-dealers are reviewed now.

Mr. SHAD. More than that are reviewed. The SRO's are, the New York Stock Exchange——

Mr. WIRTH. How many are reviewed by the SEC.

Mr. SHAD. Yes, but the real leverage of the SEC's operation is the oversight of the stock exchanges and the NASD that conduct these annual reviews, annual inspections, plus, our own systems for reviewing the filings of the broker-dealers.

Mr. WIRTH. How often, then, is the Commission, if you depend, as you do, on the SRO's—how often has the Commission sanctioned one of the exchanges or the NASD for failing to do their job and overseeing the brokerage industry.

Mr. SHAD. We provide annual letters of advice and comment on the job they are doing. Now Mr. Ketchum could give you more specific response.

Mr. WIRTH. Let me ask the other members of the Commission if you all have any sense of an adequate job being done in this area of broker-dealers.

Mr. TREADWAY. I would say that I do not have a sense of an inadequate job being done.

Mr. WIRTH. Whereas in the area of looking at the 10-Ks, you have some misgivings about that. In the area of broker-dealers you do not.

Mr. TREADWAY. That is right.

Mr. WIRTH. Mr. Cox.

Mr. COX. In the area of broker-dealers, I think that the program is working well.

Mr. WIRTH. Mr. Marinaccio.

Mr. MARINACCIO. I would have the same views Jim does of the broker-dealers.

Mr. WIRTH. Well we greatly appreciate you all coming up and being here for 3½ hours. Again, let me say, Commissioner Shad, as I have said to you and Chairman Dingell has said to you, so many times, you know it is our job to define, and develop, and approach the public interest from the perspective of the Congress.

Sometimes that is uncomfortable for you and sometimes it is not. If the relationship were always comfortable, we probably would not be doing our job.

We have enormous respect for the Commission and for the Commissioners and for the job that you do in a rapidly changing world.

I might close by saying that we look forward, as ever, to working with you. If you have ideas or suggestions where we can be helpful, in other than formal ways, we look forward to working with you on those.

We will be talking to you again, Mr. Chairman. We will follow up, as well, with questions to you and hope we can get the Commission to come up and testify on the area of mergers and takeovers.

Finally, Commissioner Treadway and Commissioner Marinaccio, again, thanks to both of you. I suspect that you, in all gratitude, will be walking out of here this morning, your last oversight hearing with the subcommittee.

We recognize your gratitude and with gratitude, we thank you for your service as well.

Thank you very much.

[Whereupon at 12:55 p.m., the hearing ended.]

SEC OVERSIGHT

WEDNESDAY, MARCH 5, 1986

House of Representatives,
Committee on Energy and Commerce,
Subcommittee on Telecommunications,
Consumer Protection, and Finance,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room 2123, Rayburn House Office Building, Hon. Timothy E. Wirth (chairman) presiding.

Mr. Wirth. If the subcommittee would please come to order.

Today we are holding our annual oversight hearing on the activities, policies, and resources of the Securities and Exchange Commission. The bipartisan concern and support for the SEC shown by this subcommittee underscores the fact that the specific issues involved in our oversight of the SEC bear on much broader public policy concerns, concerns about the integrity of our capital markets and the function of those markets in fueling long-term capital formation and economic growth, both essential to the Nation's prosperity.

Our broad public capital markets are widely viewed as the safest, fairest, and most efficient markets in the world. They have helped to make possible the extraordinary economic growth experienced in this country.

The SEC has the critical mission of protecting investors and maintaining confidence in the integrity of our capital markets. The SEC's ability to continue to protect investors and maintain the integrity of these markets has been challenged in recent years by tremendous growth in the markets under its jurisdiction.

In my written statement, which I will submit to be included in the record, I have described that growth in some detail.

In recent years, the SEC has reported substantial productivity gains. I think all of us appreciate the hard work Chairman Shad, the Commissioners, and the Commission staff have done. In many areas, those gains have failed to keep pace with the activity in the market. In certain areas, the numbers have stopped growing and we have to take a hard look behind those numbers in still other areas.

Our first task today is to evaluate the SEC's resources. Are they adequate to police our growing and increasingly complex securities markets. We also want to examine whether the SEC has sufficient statutory authority, sufficient tools, in other words, to carry out its mission of protecting investors and ensuring the integrity of our extraordinary markets.

We must also look at the overall direction and priorities of the Commission. At this time of soaring budget deficits which must be reduced, it may be unrealistic to expect the SEC to be staffed at optimal levels. We must ask if the SEC is directing its resources in the most effective fashion. We will pay special attention to the effectiveness of its oversight of the self regulatory organizations.

Finally, I should note that 1 year ago, the SEC appeared before this subcommittee in the midst of a chain of events that threatened to undermine investor confidence in our financial system as a whole—the failure of E.S.M. Government Securities followed by the savings and loan crisis in Ohio and then the failure of Bevill, Bressler and Schulman Asset Management.

Some members of the subcommittee criticized the SEC for failing to be more aggressive in dealing with the potential problem of unregulated government securities dealers. Our financial markets and institutions are so interrelated that the Commission cannot shy away from a potential problem by merely saying it doesn't have the resources or the authority to deal with it or it is the Fed's problem or someone else's problem.

As we have observed in recent years, the Fed's problem or the CFTC's problem or a State insurance commissioner's problem quickly becomes a national or even international problem affecting us all: The young couple trying to finance their first house, the entrepreneur trying to raise capital for his or her business, and the family farm trying to get financing to hold on to the family property.

We look to the Commission for leadership. I would urge the SEC to be bold and anticipating rather than reacting to problems in the markets. Protecting investors and preserving confidence in our markets is critical to maintaining the economic growth so essential to our future.

[The prepared statement of Mr. Wirth follows:]

Statement
of the
Honorable Timothy E. Wirth, Chairman
Subcommittee on Telecommunications,
Consumer Protection and Finance
Oversight of the Securities and Exchange Commission
March 5, 1986

Today, we are holding our annual oversight hearing on the activities, policies and resources of the Securities and Exchange Commission. The bi-partisan concern and support for the SEC shown by this Subcommittee underscores the fact that the specific issues involved in our oversight of the SEC bear on much broader public policy concerns -- our concerns about the integrity of our capital markets and the function of those markets in fueling long-term capital formation and economic growth, which are essential for our future prosperity.

Our broad, public capital markets are widely viewed as the safest, fairest and most efficient markets in the world, and they have helped to make possible the extraordinary economic growth experienced in this country. Investor confidence in our markets is the cornerstone of long-term capital investment in American business and industry. The SEC has the critical mission of protecting investors and maintaining confidence in the integrity of our capital markets.

But the SEC's ability to continue to protect investors and maintain the integrity of our markets has been challenged in recent years. Since the beginning of 1980:

--The volume of shares traded on the New York Stock Exchange has increased over 300%;

--The volume of shares traded over-the-counter has grown almost 500%;

--The number of registered broker-dealers has increased 80%;

--The number of investment companies has grown over 60%;

--Investment company assets have grown 300%; and

--The number of investment advisers has almost doubled.

However, SEC staff levels have remained at or below levels of six years ago.

In recent years, the SEC has reported substantial productivity gains, and I think all of us appreciate the hard work Chairman Shad, the Commissioners and the Commission staff have done. But in many areas, those gains have failed to keep pace with the activity in the market. In certain areas, the numbers have stopped growing, and we have to take a hard look behind those numbers in still other areas.

So, our first task today is to evaluate the SEC's resources. Are they adequate to police our growing, and increasingly complex, securities markets?

We also want to examine whether the SEC has sufficient statutory authority - sufficient tools - to carry out its mission of protecting investors and ensuring the integrity of our extraordinary markets. Several years ago, the Commission came to this Subcommittee and said that insider trading was a serious problem in our capital markets and that the SEC needed a more creative and effective means to deter this activity. We worked closely with the Commission in developing the Insider Trading Sanctions Act. Today, we want to explore with the Commission whether there are other areas where its statutory authority should be strengthened or clarified.

We must also look at the overall direction and priorities of the Commission. At this time of soaring federal budget deficits, which must be reduced, it may be unrealistic to expect the SEC to be staffed at optimal levels. So, we must ask if the SEC is directing its resources in the most effective manner. We will pay special attention to the effectiveness of its oversight of the self-regulatory organizations. The securities exchanges and the NASD play a critical "watchdog" role in supervising broker-dealers and protecting investors. The GAO today will say our system of self-regulation is working, but it can be improved in a number of ways. It is important for Congress and the SEC not only to focus on the strengths of our system, but to look for ways to improve it, as the SEC continues to delegate even greater responsibilities to the self-regulatory organizations.

Finally, I should note that one year ago, the SEC appeared before this Subcommittee in the midst of a chain of events that threatened to undermine investor confidence in our financial system as a whole -- the failure of E.S.M. Government Securities, followed by the savings and loan crisis in Ohio, and later, the failure of Bevill, Bressler and Schulman Asset Management. Some members of the Subcommittee criticized the SEC for failing to be more aggressive in dealing with the potential problem of unregulated government securities dealers. We were finally able to get some help from the SEC and its able staff, which prepared a report on the government securities market and helped us draft the Government Securities Act of 1985. The bill passed the House by voice vote in September and is now pending before the Senate Banking Committee.

We look to the Commission for leadership -- in anticipating problems, in helping to shape policy, and in carrying out the policies set by The Congress. We need more than just help from the Commission after a crisis. It is laudable, but not enough, to show productivity in doing the work we all know the SEC must do. The Commission also needs to be aggressive and forward-looking, as it is trying to do, I might add, in the area of the internationalization of the markets, in the area of bank securities activities and in a number of other areas.

Our financial markets and institutions are so interrelated that the Commission cannot shy away from a potential problem by merely saying that it doesn't have the resources or the authority to deal with it, or that it is the Fed's problem or someone else's problem. As we have observed in recent years, the Fed's problem, or the CFTC's problem, or a state insurance commissioner's problem, quickly becomes a national and even international problem, affecting us all -- the young couple trying to finance their first house, the entrepreneur trying to raise capital for his or her business, and the farm family trying to get financing to keep their farm.

I would urge the SEC to be bold in anticipating, rather than reacting to, problems in the markets, because protecting investors and preserving confidence in our markets is critical to maintaining the economic growth so essential for our future.

We have a very constructive morning planned today. Our first panel, preceeding the distinguished Commissioners of the SEC, consists of three commentators uniquely qualified to address these questions.

I will introduce them shortly, but will now turn to my colleagues for other opening statements.

Mr. **Wirth**. We have a very constructive morning planned today. Our first panel preceding the distinguished Commissioners of the SEC consists of three commentators uniquely qualified to address these questions. I will introduce them shortly. First, I want to turn to my colleagues for whatever opening statements they may have.

Mr. Rinaldo.

Mr. **Rinaldo**. Thank you, Mr. Chairman. I want to certainly thank you for scheduling this hearing. I am looking forward to the testimony we will receive today. I am looking forward to it because I think there are few matters more important to the national economy than the operation of the securities markets. This area is properly one of the top priorities of the subcommittee.

At the outset, I want to express my own desire for a balanced hearing record on the SEC's activities. Too often it seems we are ready to hear the worst about Federal programs or agencies without giving enough credit or recognition when agencies and programs are functioning well.

On the whole, I think the hearing will show this morning that at the SEC a great deal is going right. I think the ultimate test of the Commission's performance is reflected in the confidence we are witnessing in the markets.

As this subcommittee has noted in the past, our securities markets are viewed as the safest, fairest, and most efficient in the world. I think that is a true analysis. The markets help to fuel an enormous economic machine that provides our Nation with unparalleled wealth and the sturdy confidence that are the hallmarks of American economic society.

The SEC plays a central role in maintaining confidence in the markets. Given the enormity and complexity of the task, I believe the Commission is doing an excellent job. That doesn't mean, however, there is no room for improvement. It does mean that we shouldn't lose sight of the bottom line, and that is first of all, the markets are strong. Second, confidence is high. Third, investors are well protected by the SEC, the SRO's overseen by the Commission, and State regulators across the country.

From our witnesses this morning, I am not looking for criticisms as much as I am looking for constructive suggestions. If they feel the SEC is not doing all it should, I hope they will be able to tell the subcommittee how we can fill that gap. That doesn't simply mean increasing the SEC's budget. I believe the chairman of the subcommittee mentioned the point of fiscal constraints. Given those constraints Congress is facing, increasing the Commission's budget is simply not a realistic option.

With that perspective in mind, I welcome our witnesses and I am happy to have them with us this morning.

Thank you again, Mr. Chairman.

Mr. **Wirth**. Thank you, Mr. Rinaldo. Mr. Luken.

Mr. **Luken**. Thank you, Mr. Chairman.

I do not have a prepared statement. I observe as many have observed that the SEC apparently is swamped. The staff is struggling to cope with an enormous expansion in the securities and mutual fund industries, a crush of corporate filings, and a surge in the number of financial planners the agency must monitor. It has been observed that the SEC is horribly overmatched by the bad guys in the marketplace.

These are the things that we should be concerned about. We are not interested today primarily in the question of a budget of an agency. We are interested in examining whether the SEC has adequate staff to carry out its investor-protection mission.

The percentage of reviews it would conduct under its 1987 budget proposal mark a continuing decline over previous years. In another area, we will be looking at whether the SEC has the authority which it needs and the other regulating agencies in this field. The SRO's apparently lack authority to deny registration of broker dealers that have been convicted of serious crimes, such as drug smuggling and selling of drugs. Some of us believe they should be given that authority. The SEC should be empowered to issue cease-and-desist orders to securities law violators.

We will be examining today whether the SEC actually is seeking the authority and the powers that it needs in addition to whether it is looking for the adequate staff to do the job which it is intended to do, to protect the consumers and the investors in this country.

Thank you, Mr. Chairman.

Mr. WIRTH. Thank you very much, Mr. Luken. Mr. Leland had hoped to be here this morning but could not attend and asked that his statement be included in the record.

[The statement of Mr. Leland to be furnished follows:]

STATEMENT OF HON. MICKEY LELAND

Thank you and good morning Mr. Chairman. I appreciate the opportunity this morning to review the performance of the Security Exchange Commission and to discuss issues affecting the securities markets. Mr. Chairman, I share your concern about the Commission's ability to adequately enforce our nation's securities laws. Particularly in light of the cutbacks in Commission staff and resources required by Gramm-Rudman, I believe it essential that we carefully monitor the SEC's ability to maintain the integrity of our capital markets.

Mr. Chairman, there are also some substantive issues that concern me greatly. During the Oversight hearing this Subcommittee held last year, I expressed my concern about the prospect that the New York Stock Exchange was preparing to revise or lower its one share-one vote standard. To date the New York Stock Exchange has maintained that standard, but it is becoming increasingly clear that competitive pressures may compel it to submit a proposed change to the SEC in the near future. I am deeply concerned about what such a change would mean, and I hope we have an opportunity to revisit that issue this morning.

In recent months there have been a series of articles and much public discussion concerning insider trading and manipulation of the marketplace. I greatly fear that investor and public confidence in the integrity of the marketplace has begun to erode in the face of some of the public accounts of fraud and abuse of the marketplace. Although the Commission has adopted an aggressive stance against insider trading, a grave problem still exists. I am certain we will discuss that issue today.

In concluding, Mr. Chairman, I would like to welcome Chairman Shad and the members of the Commission. I particularly would like to welcome Commissioner Grundfest and Commissioner Fleischmann who I believe are making their first appearances before the Subcommittee. Thank you Mr. Chairman.

Mr. WIRTH. Moving now to our first panel of witnesses, they include the following gentlemen. The Honorable Royce O. Griffin, president of the North American Securities Administrators' Association. Mr. Griffin is also director of the Colorado Division of Securities. This is the first time we have had the opportunity to hear Mr. Griffin testify. Over the last 5 years, the subcommittee has heard from the North American Securities Administrators' Association on virtually every major issue facing us including the commodities securities amendments, tender offeror reform, mortgage-backed securities, and many other issues.

As Mr. Luken and Mr. Rinaldo both pointed out, the States play a major role together with the SEC in protecting investors.

We look forward to hearing from you, Mr. Griffin, and are glad to have you here.

Mr. Randy Schultz is Deputy Associate Director of the General Government Division of the General Accounting Office. Not more than 2 years ago, I asked the GAO to undertake a comprehensive study of the effectiveness of the SEC's oversight of industry self-regulatory organizations.

At this time of Federal budget austerity, the results of this study are particularly appropriate, since the SRO's may well have to shoulder more responsibilities.

The GAO has preliminary results of their study only. I would add the caveat that the report has not yet been sent to the SEC or to the SRO for comments. I hope with that understanding, we can listen to what the GAO has to say today.

I would also like to put in the record at this point the names of the GAO staff who have worked so hard on this project. We thank all of them. Without objection, that list will be included in the record.

[Information to be furnished follows:]

GAO Employees Participating in the Study of the Securities and Exchange Commission's Oversight of Self-Regulatory Organizations

GENERAL GOVERNMENT DIVISION

Craig A. Simmons—Associate Director.
John R. Schultz—Deputy Associate Director.
Gerald C. Schober—Senior Division Evaluator.
Lyle H. Lanier—Supervisory Evaluator.
Edward J. Samario—Evaluator.
Teruni Chanmugan—Evaluator.

WASHINGTON REGIONAL OFFICE

Robert J. McArter—Assistant Regional Manager.
Lawrence M. Korb—Evaluator-in-Charge.
Charles J. Williams—Evaluator.
Carol M. Wilkes—Evaluator.
Erin J. Bydalek—Evaluator.

NEW YORK REGIONAL OFFICE

Ruth R. Levy—Regional Assignment Manager.
Richard G. Schlitt—Site Senior.

CHICAGO REGIONAL OFFICE

Patrick C. Dolan—Regional Assignment Manager.
David J. Dierson—Site Senior.

Mr. **Wirth**. Our third witness is Mr. Richard M. Phillips, a partner in the law firm of Kirkpatrick, Lockhart, Hill, Christopher & Phillips. Mr. Phillips is a former SEC official and currently serves as chairman of the ABA Committee on Federal Regulation of Securities.

Today he is testifying in a personal capacity. Mr. Phillips has long been a strong supporter of the SEC and a great help to this subcommittee. He has also been a very constructive critic, both of the subcommittee and of the SEC and will help us again today with his assessment of the SEC's current activities.

Gentlemen, we thank you all very much for being with us. Your statements will be included in full in the record. We would ask that you summarize your statements in 5 minutes and then we can get to questions and answers.

Why don't we start with you, Mr. Griffin, and then go to Mr. Schultz, and then Mr. Phillips. Thank you all very much for being with us.

STATEMENTS OF ROYCE GRIFFIN, PRESIDENT, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.; JOHN R. SCHULTZ, DEPUTY ASSOCIATE DIRECTOR, GENERAL GOVERNMENT OFFICE, GENERAL ACCOUNTING OFFICE; AND RICHARD M. PHILLIPS, WASHINGTON, DC

Mr. **Griffin**. Thank you, Mr. Chairman.

I am the president of North American Securities Administrators Association. NASAA, as that is called, is the association of 65 State and provincial securities administrators. Unlike the SEC, our sole reason for existence is the protection of investors. The SEC has other interests such as regulation of the markets and capital formation interests as well.

As State regulators on the grassroots level, we see a wider range perhaps of the securities markets than people who are mainly concerned with what goes on on Wall Street and in New York. I think as a number of publications have pointed out in the last couple of years, it is an unfortunate fact that we are facing an epidemic of securities fraud in this country.

I listened very carefully to Mr. Rinaldo's remarks. I must say that I understand Gramm-Rudman and I understand that the likelihood of increasing the staff at the SEC is very small. We should, however, be aware and send the message to the people that if we do not increase the staff at the SEC, we are going to have serious shortfalls in our ability to combat securities fraud in this Nation.

I bring to your attention in this respect the fact that SEC complaints are up 42 percent. NASD complaints are up more than 300 percent. SEC staff is not up at all. There is only so much blood you can get out of a rock. It is my understanding that people at the SEC work very, very hard. However, there is a limitation to what you can get out of a static number of persons.

In this regard, I think it is absolutely essential that this committee and Congress mandate cooperation to the maximum extent possible between all jurisdictions involved in the war on securities fraud. It is essential that the SEC have the tools to cooperate with the States and with the SRO's and that they have the willingness to do so. That must be a first priority in an era where we are having increasing problems in the marketplace and no growth in the policemen to police that marketplace.

As I have said, I think the Commission has a very dedicated staff. However, it is lacking in the necessary numbers to do the job.

We particularly commend the Enforcement Division of the Securities and Exchange Commission and the Investment Management Division. We have very high hopes for the Market Regulation Division as well.

I think the upshot of what I am saying is that because of the retreat from enforcement that has taken place not because of the desire of the SEC, but because of limitations of resources, we have sent a message to scam peddlers, market manipulators, and inside traders that for the most part, deregulation means anything goes and the risks of being caught are sufficiently small, and that deterrence simply isn't working as well as it did 5 or 6 years ago in those regards.

I believe that staff levels must begin to catch up at some point in time. Maybe not this year, maybe not next year. As the staff remains static and the problem continues to increase, we are going to see a continuing loss of confidence in the marketplace that I think is reflected in the retreat of individual investors from the big board stocks.

A second mandate that you put to us, that you wish to discuss today, is increased statutory authority for the SEC. I think there are five specific areas where that authority should be increased by Congress.

First, I think Congress should make it clear as an exception to the general privacy acts or whatever is necessary, that the SEC is empowered to, and encouraged to, share information, even about open investigations, with other jurisdictions. All jurisdictions simply have too much on their plate as far as fraud is concerned today. It is essential that when States make requests for information they not be greeted with a reply that the Federal law will not permit us to share this information with you.

As Representative Luken pointed out, cease-and-desist authority, administrative authority, is an extremely important tool in an era where you do not have the resources to go to court and litigate every case that comes up. Cease-and-desist authority exists throughout administrative law. It exists on the Federal level in one form or another and it exists on the State level. It has been discussed for the SEC in the past. I think it would be an appropriate tool for that agency.

I think it is necessary for the SEC to have congressional power mandated to it to enforce subpoenas to aid self-regulatory organization investigations. My understanding is that the SRO's have no subpoena power and the SEC believes it does not have the authority to issue subpoenas in aid of those investigations. That is an area where legislation would help.

I think that the SEC should have authority to establish floor standards for certain kinds of stock offerings, floor standards in areas such as cheap stock and underwriter's compensation. This is basically merit authority. It exists elsewhere in the Federal law. It exists for investment companies under the Investment Company Act of 1940. I think it is an appropriate kind of power to prevent the kinds of really weak offerings that we see, particularly in the Rocky Mountain States and in those States that they do not exercise any State merit review authority.

Finally, I think that Congress should mandate some form of self-regulatory organization accountability to the States. Currently the SRO's are accountable only to the Federal Government and to the SEC. For that reason, in the past, when violations of State law have occurred and NASD examiners have discovered them, it is the rule rather than the exception that those violations are not reported to the States. That is an unacceptable situation, particularly in an era where we have reduced resources and where cooperation is absolutely essential to protecting investor confidence in the marketplace.

SEC priorities, I think, should be shifted away from the mad rush to deregulation. There should be some consideration given to the effects of deregulation; the side effects that deregulation carries with it. Regulation D is one of the Commission's foremost deregulatory moves. It has raised tremendous amounts of capital. I suggest that this committee look at what that capital is used for.

A third, perhaps even half of it, is used for tax shelters. In some respects, regulation D has created massive enforcement problems for the smaller States, such as in the Rocky Mountains, through the creation of shell corporations under rule 504.

The answer is well, there is usually fraud here and perhaps we should pursue it as a fraudulent case. I would suggest to you that by fine tuning the rules and paying closer attention to the side effects of these deregulatory measures, we would be in a lot better shape than if we attempted to remedy every problem that we have through litigation on the fraud side.

The EDGAR project, I know, is a hot issue in this committee and throughout Congress. We believe that EDGAR is a very useful and innovative tool that will be beneficial to regulators, to the public, and to issuers alike. However, in order to work, it is essential that EDGAR be designed with all the States in mind and that it be created in such a fashion that the States can use it.

We have been working with the SEC. We find them very cooperative in this respect. However, we still have serious concerns if the current proposals are going to permit the States to conduct any kind of meaningful reviews on documents filed through EDGAR.

Finally, on the issue of improving self-regulation, it seems to me that the SRO's must take greater responsibility, particularly in the area of sales practice regulation. This has historically not been of particular interest to the SRO's. They have concentrated on financial stability of broker dealers. This is an area that directly impacts investors and one which the SRO's are peculiarly able to address, if they so choose.

Second, we believe that the SRO's should be encouraged to regulate, rather than launch antiregulatory initiatives against the States. These initiatives are discussed in some length in my testimony and I will not go into them here, but I am more than happy to discuss them.

And, third, as I stated, under statutory alternatives, I believe the NASD has failed in the past to pass on evidence of violation of State laws to the concerned States.

It is essential that these problems be corrected if we are ever going to be able to cooperate and effectively ensure investor protection.

Thank you, Mr. Chairman.

[Testimony resumes on p. 145.]

[The prepared statement of Mr. Griffin follows:]

Statement of Royce Griffin, President, North American Securities Administrators Association

Mr. Chairman and Members of the Subcommittee:

Good morning. I am Royce Griffin, Securities Commissioner for the State of Colorado and president of the North American Securities Administrators Association (NASAA). NASAA is the association of the 65 state and provincial securities administrators from the United States, Canada and Mexico, whose charge is to administer and enforce securities laws. NASAA works to protect investors and to ensure that the securities markets operate with a minimum of abuse.

I have been asked to address you here this morning on the effectiveness of the Securities and Exchange Commission. You have asked me four specific questions: 1) does the Commission have adequate staff and other resources to carry out its mission; 2) does the Commission have sufficient statutory authority; 3) is the Commission setting appropriate priorities; and 4) how can the system of self regulation be improved.

Members of our association are located in all 50 states. We work with investors in every local securities market in the nation. From Fort Lauderdale to Salt Lake City and from Wall Street to Spokane, we see the real world of today's securities markets. I'm here to report that all is not well in America's capital markets. We are in the midst of an epidemic of securities fraud. As Forbes Magazine reported last year, this epidemic is the greatest in U.S. history, possibly amounting to $40 billion or more a year. Why? The number of Americans looking for investments has risen. The range and diversity of investment instruments has grown as well, just as the deregulatory wave has reached high tide. Not surprisingly, the number of fraud complaints received by the SEC and the National Association of Securities Dealers (NASD) has soared. In fiscal 1980, the SEC received 18,500 complaints; in 1985 it received 31,500, up 42 percent. In calendar year 1980 the NASD received 1,071 complaints; in 1985 it received 3,414, up more than 300 percent.

To police this expanded marketplace is a daunting task. Fortunately, the Commission has a dedicated staff of professionals that have long been an outstanding example of public service, and I want to applaud them for their efforts to create new enforcement tools. For example, the Commission is studying the idea of using paid informants in a manner similar to that used by some other agencies, such as the Internal Revenue Service. This is a sensitive issue, but I'm pleased that the Commission is looking into it. It shows that they're trying to do the job.

But given the growing abuses in the market to which I've alluded, the Commission is woefully lacking in adequate staff and resources. While the securities industry has mushroomed in recent years, the SEC's staff level has remained static. Consider these facts:

- The Commission's fiscal 1987 budget request would permit reviews of 19 percent of annual reports, down from 20 percent in 1986. Only 64 percent of first-time and 25 percent of repeat 1933 Act registrations would receive full review.

- SEC analysts, according to the Wall Street Journal, are reviewing less than one percent of 13-D reports, five percent of interim reports and 22 percent of 10-Ks.
- At year end 1985, the SEC reports, there were 11,597 registered broker/dealers, up from 7,700 in 1981. There were 11,753 investment advisors, up from 6,000 in 1981. SEC staff levels are the same now as they were then.

Clearly, the Commission staff has not been able to keep up with the expansion of the marketplace, and we cannot expect it to. While the Commission may point to impressive productivity gains, it won't be able to squeeze more out of its able staff indefinitely. This weakening of investor protection safeguards has not gone unnoticed by the scam peddlers and market manipulators. Too many of them seem to have concluded that "deregulation" means "anything goes." The truth is that the level of federal securities enforcement is so low that more and more shady and fraudulent deals are worth the risks for unscrupulous sellers. SEC staff levels must begin to catch up with the securities market's growth to maintain the integrity of our capital markets.

Statutory Authority

SEC resources are part of the issue. Another part is the Commission's legal authority to regulate the market. In certain areas, that authority should be enhanced.

The SEC has only 10 regional offices, and most of its staff is in Washington and New York. By contrast, the state securities agencies, whose staffs account for about a third of the entire government securities regulatory personnel, operate in every state, close to all the markets--and the fraud. It's easy to see that the regulatory system will operate best when its components--state and federal--cooperate to the fullest.

One of the biggest problems state administrators face when working with the SEC is obtaining access to the Commission's files so that we may pursue our own investigations. Often, for example, when we have sought enforcement case files, we have been told to apply for the information under the Freedom of Information Act through a regional office. In one case in North Carolina, it took six months to get the information the securities division was seeking. Where the information is often needed yesterday, this SEC practice is a hindrance to effective law enforcement. And when the SEC is pursuing an enforcement case, it says it cannot share information because of FOIA restrictions. Mr. Chairman, the states are supposed to be partners with the SEC. I don't know whether the SEC's lack of cooperation is, in fact, an FOIA problem. If the law requires time-consuming, formal requests for information from fellow law enforcement officers, then the law should be changed; if it is an SEC interpretation of the law, it should be modified.

The SEC should be given the authority to order companies or individuals to cease and desist from illegal practices. This administrative authority would allow the Commission to order securities violators to stop illegal practices without having to go to court. When these violations can take someone's life savings, time is of the essence, and the Commission should be able to stop them quickly.

We are concerned that the self regulatory organizations apparently lack authority to deny registration to securities salespeople with criminal records involving drug dealing and other serious offenses. We have compiled information from the Central Registration Depository concerning a number of salespeople, now registered with NASD, who have been convicted of felonies including importation and distribution of drugs such as cocaine, marijuana and other controlled substances. The convictions range from as far back as 1974 to as recently as 1985. The Securities Exchange Act of 1934 proscribes registration by an SRO for those convicted of crimes related to the securities business. Our understanding is that the NASD believes the law does not allow it to deny registration to those convicted of other serious crimes which raise questions about the individuals' fitness to engage in a business relying on public trust. Let me cite, without using names, two examples of dealers now registered with the NASD.

- Salesperson A pleaded guilty to felony possession of cocaine for sale in March 1981, and a felony charge of distribution of cocaine in December 1981.
- Salesperson B pleaded guilty to importation of marijuana and conspiracy in 1974; was convicted for sale of a controlled substance in 1975; and was given three years probation and a $10,000 fine for importation of marijuana in 1980.

States generally have authority, under our own laws, to deny registration to these individuals. But since most salespeople operate across state lines, it is often difficult for us to shoulder the entire burden of keeping unrehabilitated drug dealers and other criminals out of the securities business. The NASD should have the authority to deny registration to people convicted of such serious crimes.

SEC Priorities

Mr. Chairman, you've asked what the SEC's priorities should be. First, I would emphasize the point I made earlier. The first priority should be more resources, particularly in the Enforcement Division, where the staff knows how to do the job if it is given the tools. The SEC needs more resources to monitor a growing market, as I have discussed. But given unreasonably limited resources in these days of deregulatory and budget-slashing fervor, what should its priorities be?

First, the Commission should slow down its rush to deregulate. The brainpower currently used to conceive new ways to deregulate the market could be used more productively to accomplish the Commission's primary mission-- protecting the integrity of the securities markets. Some deregulatory zealots may claim, for example, that less up-front regulation (registration and review, for example) reduces the need for SEC staff resources. But the opposite is true, as demonstrated by the dramatic growth in fraud complaints. It is no accident that the boom in securities fraud tracks the boom in deregulation initiatives. Deregulation creates the need for more enforcement staff, and cutbacks in staff suggest the need to restrain the deregulatory impulse.

Second, while the SEC's efforts to combat insider trading and stock manipulation have been admirable, they have come at the expense of almost everything else.

The agency seems to have decided to eliminate review in several areas. It doesn't investigate tax shelter cases anymore. When was the last time it investigated such a case? With few exceptions, it has even shied away from major takeover battles. We have seen giant companies trade charges of securities violations, while the Commission has sat on the sidelines. The SEC Advisory Committee on Tender Offers finished its work almost three years ago. Yet the Commission has done little to halt the kind of takeover tactics that were considered unfair to small investors when the Committee was appointed. As a result, the hostile takeover boom and its abuses continue unabated.

As you know, one of the Commission's major priorities in recent years has been the EDGAR project. It clearly has the potential for reducing staff time and paperwork. The states, however, have some serious concerns about our role in it. For EDGAR to become a successful system, the states must be considered integral parts of a federal system rather than adjuncts. If the purpose of the system is to cut time and paperwork from registration, then the states and the SEC must work in tandem, because it is the final stage of review that determines when an issue will become available to the market.

The central defect in the proposed EDGAR structure is that the states would be denied direct access to the SEC's EDGAR central processing unit. Instead it is proposed that the states be transshipped the data to a separate computer and disseminated from that point. This is a costly, duplicative and, we fear, unworkable alternative. Commission staff have suggested that their position reflects their concern for the system's "security." This posture implies that they do not see, or trust, the states as partners in regulation.

Over the last two months, NASAA has responded vigorously to the Commission's proposal with written comments. We would be pleased to make those documents available to the Subcommittee. We applaud the idea of EDGAR, and we remain optimistic that we can work with the SEC for an effective system. Unfortunately, the currently proposed plan falls far short of the public's needs.

Another area in which greater coordination between federal and state regulatory policy is needed is the registration of multinational securities offerings. As you know, the Commission is pursuing discussions with Great Britain and Canada on a common-clearance system. Unfortunately, NASAA has not been invited to play a role in these discussions. For a common-clearance system to work, the states must help plan, design, and ultimately approve it. Otherwise, American investors will have to wait for the states to complete their reviews before gaining access to foreign offerings.

Another area that the Commission should examine is qualitative review of offerings. As you know, 37 of the 50 states submit new issues to some kind of merit review, a process in which securities officials weed out those offerings that tend to commit a fraud by benefitting promoters at the expense of public investors. Merit review tries to balance the interests of public investors with those of promoters. The SEC should consider requiring new offerings to pass some merit qualifications--even if only standards for cheap stock and underwriters compensation. Last week, in comments to the SEC, former SEC Commissioner Roberta Karmel argued that the Commission has ample authority to develop a Commission rule establishing a national standard for such compensation.

Last month the SEC announced that it was proposing to turn over to the states regulatory responsibility for lower level financial planning firms and investment advisors. This proposal stems from the recent proliferation of investment advisors I mentioned earlier. It is an indication that the Commission's Investment Management Division needs more resources.

Finally, the SEC should be required to examine the impact of the regulations it has implemented, for example, Regulation D. Promoted as a way to encourage capital formation for small business, it has, among other things, evolved into a convenient vehicle for tax shelters. According to a February 1985 Public Citizen report, almost one-third of the value of offerings in Regulation D's first year were for real estate and oil and gas partnerships, which are primarily tax shelter investments. What have been the enforcement consequences? Has it become mostly a boom for tax shelter promoters, rather than a significant aid to job-creating small businesses? The Commission should review its experience with Reg. D and consider adjustments to ensure that it is being used for the purposes it was devised--capital formation for small business.

Improving Self Regulation

As the Commission's budget and resources fail to keep up with the expansion of the market, the self regulatory organizations, as well as the states, must take greater responsibilities. We believe the SRO's budgets should be expanded and that the Commission must exercise greater oversight of the SROs. It should review NASD examination reports, and instruct NASD as to its priorities.

In addition, the SROs should be directed to do what they are supposed to do--regulate their members--rather than launch anti-regulatory initiatives against the states. You are no doubt aware of the "SRO warfare" that has broken out between NASD and the American Stock Exchange. NASD has lobbied state legislatures for NASDAQ exemptions, while AMEX has lobbied against these proposals. Let me share with you a few reports from the battle front.

- In Louisiana, the name of an NASD contact appeared on a State Office of Financial Institutions news release that announced the repeal of merit regulation.
- In Georgia, NASD lobbied for a specific registration exemption for its National Market System stocks, even though NASDAQ already had a general exemption, along with the New York and American exchanges, under Georgia law.
- In Wisconsin this year, NASD convinced the legislature to include in a bill granting a NASDAQ exemption a provision replacing funds lost from the registration fee with a $500 filing fee. Yet, when the bill reached the governor's desk, the NASD wrote to him asking that the fee be line-item vetoed.
- In Texas last spring, lobbyists for the NASD supported a bill that would have repealed merit review.

Mr. Chairman, are these the kinds of anti-regulatory efforts that the Congress wants the SROs to pursue, at a time of a securities fraud epidemic and limited resources? Shouldn't they be working with the states to strengthen regulatory safeguards, rather than weaken them?

The self regulatory organizations can assist the state securities agencies in combatting fraud and abuse by routinely sharing information with us. Except in rare cases, NASD has not passed on information concerning violations of state law that it has found while conducting audits.

Mr. Chairman, on behalf of NASAA, I want to thank the Subcommittee for allowing us to present our views. We are an integral part of the securities regulatory system. Our purpose in coming before you is to develop closer cooperation between the federal Commission, the SROs and the states, so that we may ensure the best possible protection for America's investors.

BEST COPY AVAILABLE

Mr. WIRTH. Mr. Schultz.
Thank you, Mr. Griffin.
Mr. Schultz.

STATEMENT OF JOHN R. SCHULTZ

Mr. SCHULTZ. Thank you, Mr. Chairman.

I am pleased to be here today to discuss our assessment that was requested by you of the oversight processes within the Commission's Division of Market Regulation. And I will briefly summarize our full statement.

We looked at three components of the market supervision and regulation area. First we looked at the SEC's compliance and surveillance inspections of SRO's. We looked at their direct broker-dealer examinations. And we looked at how they review the proposed rule changes by the SRO's.

And we came away from this effort with a view that through these programs the Commission has improved some SRO operations. I think, as Mr. Rinaldo mentioned, we should give credit where credit is due.

The Commission did uncover hundreds of violations by the broker-dealers that were missed by SRO's in their own examinations of the broker-dealers. And the SEC took actions to better assure that SRO's improved the scope and rigor of their procedures.

The SEC found numerous deficiencies in SRO regulatory compliance procedures and practices, as well as in their surveillance procedures. In the great majority of these cases, remedial actions taken by the SRO's were responsive to Commission concerns, while some of these actions, frankly, did take a long time.

On the positive side, most exchanges have implemented automated audit trails and the intermarket surveillance program is in place. However, in the area of disciplining the members of the SRO's, the Commission and its staff may never be fully satisfied with the SRO's progress.

And finally, in the area of rule changes, we found that during 1984 the Commission acted upon the SRO-proposed rule changes in a manner that was consistent with the procedure set forth in the 1975 amendments to the Securities Act.

I might say, Mr. Chairman, one thing that did concern us was in looking at the examination reports by the SEC. We did not see very much inclusions of the causes, the reasons why the SRO's missed violation at the broker-dealers. Although the SEC staff assured us they do discuss these matters with the SRO's, we feel that identifying those causes in the reports would better enable the Commission's regional and headquarters offices to identify any pervasive problems with SRO examination procedures.

That being said, that the SEC is, in fact, making major improvements through its oversight process, let me turn briefly to our perspective on the future of Commission oversight in this area.

As you know, and as others have said, the securities markets that the Commission oversees have grown, and are growing, in both size and complexity. And of course, the broker-dealer population subject to the regulation has also grown. Yet, as everyone has said, the Commission's personnel resources have remained relatively stable and have actually declined in the area of market supervision and regulation.

As again was pointed out, we are entering a period of enforced budget austerity that could result in further declines in resources. Because of this, we—the witnesses here and the subcommittee—have been concerned about the Commission's ability to continue to function as well as it has in the past.

The Commission has used, and will mention in its own statement, several approaches for managing this expanding workload with its limited workforce. And we looked at two of them. For one, the SEC is trying to refer more cases and more activity, more workload, to the SRO's themselves. Another area we looked at was the increased use of automation in order to increase the efficiency of the SEC's oversight operations.

One part of that referral to the SRO's has been cessation of the SEC-only examination program. It assigned that function to the SRO's. And it is also increasingly referring potential matters for cause examinations to SRO's. Now a cause examination, as most people may know, is one that is started for a particular reason; perhaps a customer complaint.

And more of these are going to be and have been referred to the SRO's by the SEC. While these actions have enabled the Commission to increase its oversight exams of broker-dealers, we have not seen—so far—a corresponding increase in the cause exams by the SRO's themselves. In fact, we have seen instances where the SRO's have not met their own examination schedules. We have also seen a growth in the number of complaints pending at one major SRO.

While the backlog problems may be corrected by SRO's hiring additional people, for example, we are concerned about the Commission staff's concerns over the willingness of the SRO's to investigate complicated alleged sales practice violations. And while we were doing our work at the Commission, we saw examples in inspection reports and memoranda of SRO's not paying proper attention to incoming customer complaints, not fully exploring the complaints, and not finding wrongdoing in cases where violations were clearly committed.

In light of this, Mr. Chairman, we are unsure at this point whether the SRO's can reasonably be expected to conduct increased numbers of cause examinations. We have been told, however, that the Commission will pay close attention to this cause exam referral area. And we believe that it is an important one for the subcommittee to pay attention to, also.

And of course, another way the Commission has planned to cope with its resource limitations is through increased use of automation. It plans to monitor the cause examination referral program through a computerized data base that will track referrals and their disposition.

It has also pilot tested the use of portable computers to perform routine parts of broker-dealer examinations. We have seen some results of the pilot test, and they were encouraging. But again, there are concerns that budget cuts, or the budget austerity, may in fact jeopardize this program if insufficient funds are available to buy the proper computer equipment.

That concludes my presentation, Mr. Chairman, and I would be happy to respond to questions later.

[Testimony resumes on p. 161.]

[The prepared statement of the General Accounting Office follows:]

United States General Accounting Office
Washington, D.C. 20548

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss our work involving the Securities and Exchange Commission's oversight of self-regulatory organizations. You asked us to evaluate how effectively the Commission oversees securities industry self-regulatory organizations (SROs), such as the New York Stock Exchange and the National Association of Securities Dealers. At the outset, it should be recognized that the scope of our evaluation was constrained by the fact that we do not have the statutory access to books and records at SROs and broker-dealers that we have at federal agencies. Thus, we relied on information that was available from SEC which left us one step removed from the SROs themselves.

Despite this constraint, we were still able to develop a picture of SEC's oversight of SROs and to form an opinion on its effectiveness. Thus, although our evaluation results are still tentative, we are finding that the Commission accomplishes important oversight objectives by

- --improving SRO operations through its inspection program, with improvements taking varying amounts of time;
- --effectively reviewing and approving changes to SRO rules; and
- --uncovering violations of varying severity that were missed in SRO examinations, though the Commission does not consistently identify the causes of the omissions.

BEST COPY AVAILABLE

In recent years, however, concerns have been raised about the Commission's continued ability to perform its job effectively because the securities market is growing in both size and complexity while the Commission's resources have remained relatively stable. The results of Commission efforts to deal with these developments are still uncertain, and the question of how intrusive the Commission should be in its conduct of industry oversight remains undecided.

The work I am here to discuss today is part of our work on various aspects of the Commission's operations that is being done for you and Chairman Dingell of the Subcommittee on Oversight and Investigations. In addition, we have undertaken a series of studies assessing regulatory alternatives to the largely unregulated Treasury securities market at the request of Chairman Fauntroy of the Subcommittee on Domestic Monetary Policy of the House Banking, Finance, and Urban Affairs Committee.

SCOPE OF REVIEW

We defined Commission "effectiveness" to mean the accomplishment of certain program objectives in three areas:

--broker-dealer examinations,

--inspections of SROs, and

--reviews of SRO-proposed rules.

We measured effectiveness by pursuing three principal lines of inquiry. First, we analyzed the extent to which the Commission, through its broker-dealer examination program, identified violations of securities laws and regulations missed by SRO examiners, identified the reasons for the omissions, and acted on those reasons. Second, we reviewed the disposition of findings uncovered in Commission inspections of SROs. Third, we assessed the Commission's compliance in its review of SRO-proposed rules with procedures specified in the Securities Exchange Act. In conducting this work, we reviewed Commission examination and inspection reports and information relating to the review of SRO proposals.

We performed most of our work at the Commission's headquarters in Washington, D.C., and at its Washington, D.C., New York, and Chicago regional offices. These three regional offices performed more than half of the Commission's broker-dealer examinations and were located near the nation's major SROs. The SROs where we had the most extensive discussions were the National Association of Securities Dealers, the New York Stock Exchange, the American Stock Exchange, and the Chicago Board Options Exchange. In 1984 these SROs accounted for all over-the-counter trading, about 88 percent of stock share sales at exchanges, and about 77 percent of options activity.

THE CONCEPT OF SELF-REGULATION

Self-regulation in the securities industry entails SROs directly regulating their member brokers and dealers and the Commission overseeing that process. SROs regulate their members by writing rules governing their conduct, examining them to

BEST COPY AVAILABLE

detect violations of law or of Commission or SRO rules, and disciplining them for improper behavior. The Commission oversees this direct regulation by, among other things, inspecting SROs, reviewing SRO-proposed rule changes, and reexamining broker-dealers that the SROs have already examined. The Commission also performs some direct regulatory tasks, such as examining broker-dealers under specified circumstances.

Although self-regulation offers benefits such as reduced government involvement and expenditures, it also carries risks. The primary danger is that self-regulators--groups of industry professionals--might be less diligent than might be desired because they are regulating their own industry.

A key question concerning self-regulation has centered on the proper balance between self-regulatory autonomy and the protection of the public interest through government intervention. The balancing of regulatory responsibilities between the Commission and the SROs has evolved over time, subject to interpretation by industry participants and the Congress. In 1975 the balance tipped somewhat toward an increased federal role when the Congress gave the Commission additional tools to use against SROs to ensure compliance with laws, regulations, and rules.

COMMISSION OVERSIGHT EFFECTIVENESS

In the remainder of my testimony I would like to expand on the results of our work by pursuing two main themes:

--the conduct of the Commission's oversight program to date and

--the changes that are occurring in the securities industry and the Commission's response to those changes.

Conduct of the Oversight Program to Date

The Commission oversees the quality of SRO regulation by directly examining broker-dealers, inspecting the SROs, and reviewing proposed changes to SRO rules. With regard to its broker-dealer examination program, the Commission reexamines broker-dealers for compliance with various laws and regulations after the SROs have conducted their exams. In reexaminations, the Commission is supposed to identify deficiencies at the broker-dealers and evaluate the quality of work done by the SROs at the broker-dealers. An SRO's examination performance is judged to a great extent by determining whether violations existed at a firm but were not detected by the SRO and, if so, why they were not detected. Commission examiners also determine if the scope of an SRO's examination was adequate and if actions taken by SROs to remedy deficiencies were appropriate and effective.

Between fiscal years 1982 and 1984 the Commission found hundreds of violations each year of varying severity that had been missed by SROs in the course of conducting their examinations. One of our primary concerns with such missed violations was whether or not they had contributed to the subsequent failure of a broker-dealer. We found that, with the exception of the case involving an SRO's failure to discover fraudulent activity that was cited in the Commission's 1983 annual report, this has not been a problem. Of the 16 broker-dealers entering Securities Investor Protection Corporation liquidation proceedings in 1983 and 1984, there was no other case in which the SEC's discovery of violations missed by an SRO led to a firm closing immediately afterwards.

In general, where missed violations were found, the Commission communicated with the SROs. And, SROs took steps to improve their examination programs, steps that the Commission believes should in the future reduce the number of violations missed. For example, one SRO has assigned more persons to each examination, hired ex-Commission employees, and initiated new programs.

While the Commission found numerous missed violations and communicated with the SROs, not all regional office reports identified the reasons why the SROs missed the violations. Thus, we could not always determine why the SROs were missing violations. Reasons we did see in reports included: weaknesses in examination procedures, misapplication or apparent unfamiliarity with rules, and errors by individual examiners. In 1982 the Commission emphasized the importance of identifying causes for missed violations in written guidance issued to its regional offices. However, of the 132 examination reports we reviewed in three regions (59 completed by the Commission before the 1982 guidance was issued, and 73 afterwards), most did not contain any information on causes of missed violations. We believe that identifying the reasons why SROs miss violations, particularly those that are serious, is an important component of any effort to improve the quality of broker-dealer examinations. It therefore is important that, as an integral part of its oversight of the quality of SRO examination procedures, the Commission reemphasize that reports on missed violations should identify cause.

The second area of Commission oversight that we reviewed involved regulatory compliance and surveillance inspections of the SROs. These inspections are conducted to assure that the SROs are complying with securities laws and regulations and providing adequate mechanisms for detecting price and other forms of market manipulation by members. We reviewed 14 regulatory compliance inspections that identified 79 deficiencies and we also reviewed 40 surveillance inspections that identified 276 deficiencies. These inspection reports were sent to the SROs between calendar years 1980 and 1984. In general, the Commission was satisfied that identified problems had been resolved. Perhaps most noteworthy is the fact that the Commission has encouraged SROs to make the investments necessary to update, refine, or modernize systems for collecting trading information to better monitor market activity and broker-dealer trading and, for the most part, these systems are in place. However, in some instances, the Commission has not been completely satisfied with progress made in the area of SRO disciplinary measures.

Though securities laws give the Commission authority to use formal remedies, such as censuring SROs or their officers and limiting their business to get them to resolve deficiencies, the Commission prefers a give-and-take negotiating process. Because of this, it can take a very long time to resolve highly complex or controversial problems. As an extreme example, since 1963 the Commission has been trying to get the New York Stock Exchange to develop an accurate automated system to record securities transaction data. While the system was in place as of 1984, accuracy problems still existed. At the other extreme, SROs have resolved relatively minor deficiencies very quickly, even before receiving the Commission's inspection report.

It is difficult to say how long it should take to correct deficiencies identified in SRO inspections. Within the Commission there is a general belief that, if SROs can be persuaded of the need for a corrective action, they are more likely to take it. The question is how long should it take to resolve differences of opinion over the existence of identified problems or proposed solutions.

Our final area of inquiry was the Commission's rule review process. The Commission has broad authority to review and either approve or deny SRO-proposed rule changes covering such areas as membership requirements, securities listing requirements, and business conduct. The purpose of the rule review process is to assure that proposed rule changes conform with the intent of securities laws and applicable rules and regulations. During its review the Commission must comply with procedures and requirements designed to provide for public comment on, and timely review of, proposed rule changes.

We reviewed 306 proposed rule changes that were submitted to the Commission and approved during 1984. In general, we found that

--rule changes were acted upon by the Commission within reasonable timeframes and

--the opportunity for public comment was adequately provided for.

One-half of all proposed rules were published for comment within 22 days and one-half of all rules were acted upon within 36 days of their publication. Proposed rules were published in the Federal Register; comments were sought and public files were maintained.

In addition, we found that

--SROs viewed favorably the Commission's guidance on submission of proposed rule changes and

--SROs also viewed favorably the quality of Commission staff review of proposed rule changes.

Changes in the Regulatory Environment and Resulting Commission Actions

I indicated at the beginning of my statement that changes in securities markets over the past few years have created new challenges for the Commission in continuing to oversee their operations. The crux of the dilemma is that, while the market has grown both in size and in complexity, the Commission's personnel resources have remained stable or even declined in some areas. I know that this Subcommittee and Chairman Dingell of the House Committee on Energy and Commerce have expressed concern about this in past oversight hearings. According to the Commission's fiscal year 1986 budget estimate, staff resources devoted to market oversight have declined by 9 percent since 1980; now, we see increased emphasis on deficit reduction measures keynoted by the Gramm-Rudman-Hollings legislation.

While it is not possible to predict precisely how market integrity may be affected by this dilemma, I would like to offer some observations on the nature of the market changes and on the Commission's attempts to deal with them while keeping within its desired or imposed resource levels.

Between 1980 and 1984, the volume of trading on exchanges and on the over-the-counter market more than doubled and it is still growing. The number of broker-dealer firms increased by over 50 percent and the increase in branch offices was even higher. Overall employment in the industry increased by nearly 70 percent between 1980 and 1984. In other words, there is a lot more going on in securities markets today than there was just five years ago and, consequently, there is a need for increased coverage of oversight.

The growing interdependence of business relationships between financial services industry participants has caused an increased vulnerability of markets to widespread disruption. As ESM clearly demonstrated, it does not take much of an incident in today's environment to severely disrupt financial markets and erode public confidence in them. A few years ago, the ESM debacle might have been a more isolated incident. Thus, there would appear to be a need for increased thoroughness in the oversight of the activities of market participants.

In addition to these phenomena, there has been a proliferation of new product offerings and other trends in the market that have resulted in increased Commission responsibilities. For example, the Commission has received the responsibility of reviewing proposals to trade futures contracts on stock indices. It must also address regulatory issues related to trends toward greater numbers of foreign transactions in U.S. equities and greater holdings of foreign stocks by U.S. institutions.

Despite these developments, the Commission's personnel levels have remained relatively stable over the last 5 years, although there has been some growth in the size of its budget. Indeed, in the areas of oversight we reviewed, the number of people has actually declined since 1980. Coupled with this, we are entering a period of severe budget austerity, and the option of devoting more federal resources (personnel or otherwise) to oversight of securities markets may not be a realistic one. The Commission needs to seek more efficient ways of regulating and overseeing financial services industry participants. Regardless of the means chosen, it is important that the trust that investors place in the workings of these markets or the integrity of their participants not be compromised.

The Commission is trying several means to manage its expanding workload with limited resources. The Commission has dealt with its expanding workload by turning more regulatory responsibility over to the SROs, and it has tried to increase the efficiency of its examination workforce. The outcome of these approaches is as yet uncertain.

With regard to increasing SRO responsibilities, the Commission has turned over Securities and Exchange Commission Only (SECO) exams to the SROs. Under the SECO program, the Commission had directly regulated and examined broker-dealers that did not belong to an SRO. In addition the Commission has transferred more responsibility for cause exams (those that are based on customer complaints or other intelligence information) over to the SROs. As a result of these actions, the Commission has increased the number of oversight exams it conducts. But, as yet, we have not seen a corresponding increase in the number of cause exams by SROs.

In the course of our work, Commission staff expressed concern about the willingness and ability of SROs to investigate and prosecute complicated alleged sales practice violations.

They were also concerned about the SROs' ability to conduct an increased number of exams. Our data indicate that SROs have not always been able to meet their exam schedules and that the number of complaints pending investigation by one major SRO has risen.

SRO officials believe they can handle their increased responsibilities, and in some cases SROs have increased their staffing to deal with the situation. Nevertheless, we are unsure at this point how the Commission's actions will affect the broker-dealer examination program; it is simply too soon to tell.

This transfer of Commission responsibilities will need close scrutiny in the future to determine how well it is working. In our opinion monitoring workload and backlog statistics is relatively straightforward. However, ascertaining the extent to which sales practice violations are fairly and effectively dealt with by SROs involves considerable judgment and will therefore prove considerably more difficult.

One of the other ways in which the Commission has planned to cope with the increased workload is through increased use of automation. According to SEC officials, the Commission is using or plans to use automated data processing technology to improve its ability to monitor the referral program and to improve the efficiency with which oversight exams are conducted. For example, in 1985 the Commission pilot tested a program that fully automated key portions of broker-dealer exams, such as schedule preparation, and found that time savings were significant. But according to Commission officials, full implementation of this program may be jeopardized by lack of funds for acquiring computers.

We have not studied the efficiency gains that might be expected from the use of microcomputers in on-site examinations of broker-dealers. But if their application does result in significant reductions in the labor intensity of examinations, then use of automation may be one effective means of dealing with growing oversight demands.

Mr. Chairman, this concludes my prepared statement. I will be happy to respond to any questions you or other members of the Subcommittee may have.

Mr. WIRTH. Thank you very much, Mr. Schultz, and we all look forward to the completed GAO report and then getting reactions back from various industry groups to your conclusions.

Mr. Phillips.

STATEMENT OF RICHARD M. PHILLIPS

Mr. PHILLIPS. Mr. Chairman and members of the subcommittee, I am particularly grateful for this opportunity to appear here today because in all my 25 years of securities practice, both as a Commission staff member and as a private lawyer, I have never been more concerned about the ability of the Commission to promote full disclosure, prevent fraud, and otherwise enforce the Federal securities laws.

During the past decade, the growth of securities activities and in the Commission's regulatory responsibilities has been truly explosive. Trading volume in equity securities have increased 700 percent. Increases in volume for other securities have been equally dramatic. The number of broker-dealers, registered securities representatives, investment companies, investment advisers, and every other facet of Commission regulation has increased substantially, twofold, threefold, and fivefold.

It is astounding, therefore, to learn that there is one statistic that has not increased at all and, in fact, has decreased. That statistic relates to the size of the SEC staff. Over the past 10 years, the SEC staff has decreased almost 5 percent.

The record of the SEC's performance demonstrates, I believe, that notwithstanding hard work and good management by the members of the Commission, Chairman Shad, and the staff, the Commission in fact has not been able to cope with its increase in regulatory responsibilities.

The Commission has claimed a 41-percent increase in enforcement activity over the past 5 years. In fact, to the extent that statistics are a measure of the effectiveness of enforcement, they show a decline in enforcement activity over the past 10-year period.

Look at the facts. Injunctive actions and administrative proceedings instituted by the Commission have declined from 316 in 1975 to 265 in 1985. In 1985 the total number of persons named in both injunctive actions and administrative proceedings was only 584. In 1975, with a much smaller level of activity, the Commission enjoined 749 persons in injunctive actions alone. This decline in enforcement activity has taken place notwithstanding a tripling in the volume of investor complaints.

The ability of the staff of the SEC to cope with increased workloads in both its Corporation Finance and Investment Management Division is equally distressing. For example, in 1985 the staff was able to review fully only approximately 20 percent of the annual reports and proxy material filed with it. It reviewed completely only 5 percent of the quarterly and other interim reports.

Moreover, notwithstanding some truly impressive and real productivity increases in the Investment Management Division, the Commission's inspection program for investment companies in 1985 achieved only half its announced goal of examination of each company once every 2 years. Despite the fact that 85 percent of the investment company inspections in 1985 required some form of remedial action and 15 percent involved deficiencies that required further investigation, the Commission expects to do no better in the future.

In fiscal 1987, it expects it will be able to examine only one out of every four investment companies, covering 15 percent of industry assets. Based on my experience with the recent growth of the investment company industry, I doubt that its goals can be fulfilled and that its expectations will be met because the workload threatens to increase substantially.

The Commission's ability to inspect investment advisers is even more distressing. Only 9 percent were examined in 1985, an inspection cycle equivalent to 1 in every 10 years.

Frequent examination of SEC filings, inspection of the businesses subject to its regulatory jurisdiction is the keystone of effective compliance. Those who are subject to SEC regulation must be aware of its continuing presence. They have to be aware that when they file documents with the SEC those documents will be examined; and if there are deficiencies, they will be noticed and, if appropriate, prosecuted. Those doing business in the securities markets must be aware that the Commission will be in to look at their books and examine their operations.

Without that continuing presence, there will be a deterioration in compliance. And without compliance, in my view, there cannot be maintenance of investor confidence in the securities markets. The SEC—an effective SEC, in my view, is critical to the maintenance of that confidence.

The situation calls for decisive action. It calls for an increase in the Commission staff. I believe 50 percent would not be too much. Indeed, it is minimal.

These increases can be accomplished without an unfair drain on the Treasury. In 1985 the fees collected by the Commission from those utilizing its services exceeded its budget by more than $37 million, an amount equal to 35 percent of its budget.

It is not unfair to charge those who use government services the cost of providing them. It is unfair to make those persons pay for more than they get. And that is what has been happening in the field of securities regulation.

But even at the price of unfairness, in order to prevent any impact on the Federal deficit, I would support an increase in SEC fees necessary to cover a larger budget. In my view, it is a small price to pay for maintaining investor confidence and a small price to pay for the effective SEC that is necessary for that confidence.

Thank you.

[Testimony resumes on p. 194.]

[The prepared statement of Mr. Phillips follows:]

STATEMENT OF

RICHARD M. PHILLIPS

Before the
Subcommittee on Telecommunications and
Consumer Finance
of the
House Committee on Commerce and Energy

March 5, 1986

Mr. Chairman and Members of the Subcommittee:

My name is Richard M. Phillips. I am an attorney in private practice with the Washington, D.C. law firm of Kirkpatrick & Lockhart. I have specialized in the practice of securities law for more than 25 years; first, as a member of the Securities and Exchange Commission Staff and, more recently, in private practice. I also serve as Chairman of the Committee on Federal Regulation of Securities of the American Bar Association, and I am a former Chairman of the Executive Council of the Securities Law Committee of the Federal Bar Association.

I appear here today, however, only in my individual capacity. The views expressed are my own and should not be attributed to any organization with which I am affiliated.

I want to thank you, Mr. Chairman, for inviting me to appear before the Subcommittee in its oversight hearings on SEC policies and budget. I am particularly grateful for this opportunity because, in all of my years of securities practice, I have never been more concerned about the adequacy of the SEC's resources to prevent fraud, promote full disclosure and otherwise safeguard our securities markets.

A. The Basic Problem -- Inadequate Staff Resources

The growth in the securities market and in the Commission's responsibilities has been explosive. Over the past 10 years the volume of transactions in equity securities has increased more than 700 percent.[1] Trading in corporate debt instruments, as well as securities options, has increased dramatically. This 10-year growth record has been accompanied by a tremendous increase in the Commission's workload, including:

- a 75 percent increase in public offerings of securities registered with the SEC;
- a 220 percent increase in the number of broker-dealers registered with the SEC;
- a 400 percent increase in the number of registered representatives associated with those broker-dealers;
- a 225 percent increase in the number of registered investment advisers; and
- a 75 percent increase in the number of registered investment companies -- with assets in 1985 of more than $525 billion, a 600 percent increase since 1975.

---

[1] The statistics presented in this statement are derived from the Commission's Budget Estimate submissions to Congress and its Annual Reports. These statistics are summarized in the tables attached to this statement.

It is astounding to learn, therefore, that the one significant statistic related to the securities industry that has not increased and, indeed, has decreased, is the size of the SEC Staff. Over the last ten years, the Staff has declined from 2,144 to 2,046 -- almost five percent.

The Commission has claimed that, notwithstanding the huge increases in nearly every activity subject to its jurisdiction, it does not need substantial additional staff because its statistics show increased productivity from its existing staff. I do not dispute the managerial effectiveness of Chairman Shad and his able and dedicated Staff. Their accomplishments with limited resources have been impressive. But statistics alone can be a misleading measure of productivity. An examiner can be more productive by reviewing one SEC filing in a day rather than eight filings, if a more thoroughgoing review is necessary to identify deficiencies and prevent fraud. More importantly, productivity increases squeezed from existing staff, even if valid,[2] cannot cope with 75 to 400 percent increases in potential workload in most facets of SEC regulation during this past decade. Moreover, if the predictions of many analysts that the market will continue to see significant increases are anywhere near correct, the worst is not over -- it is just beginning.

---

[2] In fact, according to the SEC's Budget Estimate for Fiscal Year 1987, productivity increases were attributable in part to the donation of time by the SEC Staff -- a reflection of the Staff's willingness to work without compensation but not of productivity increases.

B. The Decline In SEC Enforcement Activity - 1975-1985

The Commission relies heavily on statistics showing a 41 percent increase in enforcement actions during the period 1981-85 to support its claims of greater productivity. Reliance on statistics alone, however, is particularly questionable in evaluating the effectiveness of the SEC's enforcement program. The Commission's enforcement staff is able, hardworking and highly productive. But any enforcement staff, if it chooses, can readily double its enforcement statistics simply by prosecuting the simple cases and avoiding the complicated ones. For instance, in recent years the Commission has, for good reasons, initiated many Section 16(a) reporting cases. In general, these cases are much simpler to investigate and prosecute than many other types of cases. Moreover, in recent years the Commission, again for good reasons, increasingly has tended to institute enforcement action against a portion of the targets in a single investigation while continuing the investigation and instituting subsequent actions against other targets. While there is absolutely no evidence of bad faith on the part of the Commission, these factors may improve the Commission's enforcement statistics without actually affecting the level of enforcement activity.

Quibbling over the Commission's statistics and claims of increased enforcement activity, however, misses the important point. In fact, to the extent that statistics are a reliable measure of productivity, a comparison of the Commission's enforcement activities in 1975 with those in 1985 indicates that the level of such activity, notwithstanding suggestions to the contrary, has actually decreased. In 1985, the Commission instituted a total of 265 injunctive actions and administrative enforcement proceedings. A total of 584 persons were named in both types of these enforcement actions. By contrast, in 1975, the Commission instituted 316 such actions and proceedings. Some 749 defendants were enjoined in injunctive actions alone.

This indication of a decrease in enforcement activity from 1975 is very disturbing.[3] Given a 700 percent increase in equity securities trading volume, a 400 percent increase in securities salesmen, a more than 200 percent increase in registered broker-dealers and investment advisers, as well as increases in many other sectors of Commission activity, one would have expected that the level of enforcement activity at the Commission would have increased significantly. Certainly it should not have decreased.

My concern over the ability of the Commission's enforcement program to keep pace with increased securities activity is confirmed by an analysis of investor complaints. The Commission has reported that it received more than 31,000 investor complaints during fiscal 1985. This volume of complaints, despite rising market prices, is more than triple the number of investor complaints reported by the Commission in 1975. Yet, as I have noted, the level of enforcement activity in 1985 declined from the 1975 level.

---

[3] The level of SEC enforcement activity in 1975 was not atypical, but similar to 1974 and 1976 levels.

In 1985 the Comission has been able to investigate only a small fraction of the investor complaints referred to it. It has attempted to dispose of an increasing number of complaints in recent years by referral to self-regulatory organizations and state securities regulators -- entities that are subject to severe jurisidictional limitations and have been hard-pressed to cope with the increasing volume of securities activity. This is particularly true of state securities regulators, whose budgets have traditionally been small and who are now subject to further pressures as reductions in the federal budget cause more responsibilities to be shifted to the states.

The Commission maintains no records that enable it to determine whether these agencies have been able to take effective action on matters referred to them. It is my experience -- as well as the experience of others -- that, to an increasing extent, investor complaints are not acted upon because of the inadequate staff resources of these agencies as well as the Commission. The failure to investigate valid investor complaints thoroughly, either directly or with the cooperation of self-regulatory agencies and state securities regulators, is a substantial weakness in the Commission's enforcement program. Very often, investor complaints are the first indication of serious and, potentially, widespread fraud or misconduct. Inability to investigate misconduct at its incipient stages allows it to develop and grow until it explodes on the financial pages of the national news media. Too often SEC investigations follow news reports of a financial debacle rather than ferreting out or preventing the debacle in the first place.

The virtually complete absence of Commission enforcement efforts against fraudulent tax shelter investments is also very disturbing. Tax shelters have become a multi-billion dollar industry that is attracting investment by an ever-widening sector of the American public. In my experience, there are widespread abuses in tax shelter offerings that have never been effectively attacked by the Commission. These abuses range from fraud in offering circulars to misappropriation of money that has been invested. Given the scarcity of Commission resources, I cannot quarrel with the decision to focus enforcement efforts in other areas. However, I do quarrel with the failure to recognize the need for more resources to deal effectively with abuses in the tax shelter area and to enforce, throughout all segments of the securities industry, compliance with the disclosure requirements of the federal securities laws.

The lack of adequate enforcement resources also has forced the Commission to virtually abandon any meaningful enforcement participation in hostile tender offer battles, notwithstanding the importance of compliance with Commission tender offer rules in such situations. Meaningful enforcement of tender offer rules, because of the fast pace of hostile tender offer battles, requires an ability for instantaneous mobilization of substantial resources. Given the limitations on the Commission's resources, I again do not quarrel with the Commission's choice of priorities in foregoing active enforcement participation in this area. The Commission's abandonment of participation in this area, however, has reduced the perception of the Commission as referee and enforcer of tender offer rules, to that of a bystander and paper tiger. It is a perception that, if left undisturbed, can seriously undermine the credibility of the Commission and the enforcement of the securities laws.

In its Fiscal 1982 Budget Estimate the Commission commented on the results of its 1980 enforcement program and warned that "without additional resources the enforcement staff may well be unable to investigate an increasingly greater number of indications of serious securities violations which are brought to its attention." Since then, the Commission's Enforcement Staff has dropped, from 686 in 1980 to 654 in 1985, and the record is confirming the validity of that warning. Nevertheless, the Commission's 1987 Budget Estimate and 1985 Annual Report contain no such admonition, despite the reduction in the Enforcement Division's Staff. In my view, the failure of the Commission to call for a substantial increase in its enforcement resources is simply irreconcilable with the need for greater enforcement activity to cope with the explosive growth of securities activity.

C. Full Disclosure Requirements -- The Inadequate Level of Staff Examination

Historically, the Commission's compliance program for full disclosure focused on Staff examination of all registration statements for public offerings of securities filed under the

Securities Act of 1933. In the 1960s, when I was a member of the Commission's Staff, virtually every 1933 Act registration statement -- not simply those filed by companies making initial public offerings -- was examined by the staff, and letters of comment pointing out any deficiencies were regularly furnished to the issuer and its counsel before the registration statement became effective. The practice of SEC staff scrutiny, together with the "due diligence" investigations of underwriters and their counsel, has been responsible for the great care traditionally taken in the preparation of prospectuses for public offerings. Such prospectuses generally have been regarded as the most reliable of any public disclosure statement.

Staff examination of 1933 Act registration statements is today an eroding tradition. The Staff reviewed 60% of the registration statements that were filed for initial public offerings during 1985. The initial registration statements excluded from examination include those filed by banks and thrift institutions in connection with holding company reorganizations on the ground that such companies have been filing disclosure documents with their appropriate regulatory agency. In fact, the standards applied by those agencies are, in some material respects, very different than those applied by the Commission, and there would appear to be a substantial need for Staff examination of these first-time SEC filings.

The Commission also has reported that in 1985 it was able to examine only one-quarter of the repeat 1933 Act registration statements for public offerings of securities. Many of these repeat filings are made under the Commission's integrated disclosure rules, which permit publicly-held companies making offerings of securities to incorporate into their 1933 Act registration statement the annual and interim reports and the proxy statements filed under the Securities Exchange Act of 1934. Accordingly, the disclosures for such public offerings of securities consist mainly of those contained in the company's annual and other reports, as well as proxy materials, filed with the Commission.

When the Commission's integrated disclosure rules were adopted, concern was expressed over the ability of the Commission to maintain the quality of disclosures in connection with public offerings of securities. Since the integrated disclosure procedures do not provide underwriters with the same opportunities for due diligence investigation traditional to 1933 Act disclosure practice, it is critically important to the maintenance of disclosure standards that the 1934 Act filings receive thorough Staff examination.

The Commission, however, has been unable to satisfy this objective. In 1985 only about 21 percent of the annual reports received a full review by the Commission's staff. Another 4 percent were monitored and 75 percent were not reviewed or monitored at all. Even that level of examination reflects an increase over previous years and was accomplished only with substantial use of unpaid overtime on the part of the Commission's Staff and at the expense of significant improvements in its examination efforts for quarterly and other interim reports and proxy materials. In 1985 only about 5 percent of quarterly and current reports and 20 percent of annual meeting proxy statements were reviewed; and only about 25 percent of quarterly and current reports and 4 percent of annual meeting proxy statements were monitored. The remainder were neither reviewed nor monitored.

Thus, the current SEC review cycle for annual and interim reports filed by publicly held companies means that, on average, the disclosures contained in annual reports will be reviewed fully by the Commission's Staff only once every five years and those contained interim reports once in 20 years. In my view, these review cycles are woefully inadequate to maintain satisfactory compliance with the disclosure requirements of the federal securities laws. The Commission's examination process must create a continuing awareness of its watchful eye by those responsible for the preparation of SEC filings. Those persons must know that there is a high probability that disclosure documents filed with the Commission and disseminated to the investing public will undergo careful scrutiny to detect any deficiencies. That awareness is absent today, and if -- as the Commission quite reasonably predicts -- there will be a substantial increase in filings, the situation will only worsen.

The Commission contends that the Staff's effectiveness in the examination of disclosure documents will improve with the use of the computerized filing and retrieval program known as EDGAR (acronym for Electronic Data Gathering And Retrieval). In my view, EDGAR represents a most farsighted program instituted by

Chairman Shad, and should be encouraged. It will enable the Commission to keep pace with the advent of computer technology in the filing and processing of disclosure documents. However, EDGAR, as its name suggests, basically facilitates the gathering and retrieval of data. While it may assist in analysis, it is not a substitute for review and careful analysis by the Commission's Staff. Moreover, any significant impact on Staff efficiency and effectiveness must await the full introduction and satisfactory operation of EDGAR. Those results cannot reasonably be expected for a substantial number of years.

The inadequacy of Commission resources in the examination of disclosure documents has been reflected in a decrease of referrals from the Division of Corporation Finance to the Enforcement Division. In 1984, the Division of Corporation Finance referred 94 matters to enforcement for further investigation and action. In 1985, that figure dropped to 80. The reduction in enforcement referrals significantly affects the Commission's ability to enforce compliance and promote full disclosure requirements. Such compliance must be administered by the Commission on a day-to-day basis through Staff analysis and examination of filings, comments on deficiencies and prompt follow through on enforcement actions when satisfactory corrections are not made. This requires manpower, and the Commission simply cannot do much more with its existing resources than it already does.

D. Regulation of Investment Management -- Inadequate Resources Despite Impressive Productivity Increases

The growth of the investment management industry in recent years has been particularly dramatic. At year-end 1985, assets held by the investment company sector of the industry alone amounted to more than $ 525 billion, having increased from $ 74 billion in 1975. The number of investment companies has increased from 1,399 in 1975 to 2,458 in 1985, and the regulatory burden on the Commission has, in fact, exceeded this increase.[4] Moreover, the number of investment advisers registered with the SEC has increased 225% from 3,420 in 1975 to 11,146 in 1985. Those advisers now manage assets valued at $1.2 trillion.

The Commission has been able to cope far better than might be expected with the staggering increase of workload in the administration of the Investment Company Act of 1940 and the Investment Advisers Act of 1940, the two statutes that regulate the investment management industry. The Commission's relative success in this respect is attributable to significant productivity gains emanating from administrative changes instituted by the present Commission and leadership in the Division of Investment Management. These changes include:

---

[4] The increase in individual investment company registrants tends to understate the increased regulatory workload because recent tax rulings have allowed investment company sponsors to create additional investment portfolios within the structural framework of single investment companies in lieu of creating new investment companies. For many regulatory purposes, however, each separate portfolio of an investment company is treated as a separate investment company.

1. Major simplification of mutual fund prospectus disclosure, and automatic effectiveness of routine post-effective amendments to registration statements containing those prospectuses.
2. Thorough-going revamping of inspection procedures that has shifted the focus of Commission inspection of investment companies from individual funds to fund complexes and has more effectively used data generated by the computer systems of the fund management organizations.
3. Continuing codification of the more common exemptive applications into Commission rules, thereby eliminating the need to file and process individual exemptive applications for these more routine matters.

Notwithstanding these truly impressive management innovations, the Staff of the Investment Management Division, which is responsible for administering the regulation of the investment management industry, faces a staggering workload. As the Division itself reports, between 1984 and 1985 there was a 56 percent increase in the number of investment adviser filings. The complexity of those filings has also increased. Moreover, the pace of industry growth is accelerating in 1986 as mutual funds attain new heights of popularity, and closed-end funds, once a dormant sector of the industry, have suddenly been rediscovered by the investment banking industry. This industry growth is not only straining the resources of the Commission, it is also straining the resources of mutual fund organizations.

Moreover, new organizations are being formed by entrepreneurs with little experience in this complex industry and little awareness of its complexities. All of these factors accentuate the need for substantial augmentation of SEC resources to maintain regulatory vigilance in this highly sensitive industry that attracts the savings of the broadest segment of the population.

Wholly apart from the prospects for awesome further industry growth, the Commission does not have adequate resources to handle the existing workload generated by the investment management industry. This is evidenced by the growing inability of the Division to process applications for exemptions from various provisions of the Investment Company Act, which frequently are required to permit the development of innovative products and to avoid the unintended application of various provisions of the Act. Despite the efforts of a conscientious Staff, the processing of routine applications can take several months, and complex applications may often languish for two or three years. Moreover, the inadequacy of Staff resources has made it exceedingly difficult for the Division to continue its codification of the more routine exemptive applications into Commission rules in order to manage its future workloads.

The inadequacy of Staff resources for the regulation of investment companies is also evidenced by the Staff's inability to make significant progress in examining the widely recognized need for a comprehensive review of Investment Company Act regulation in the light of the substantial growth and change in the industry. For example, a particularly important aspect of that growth has been the emergence of institutional funds that are marketed not to individual investors, but to pension funds, banks and other institutions. Such mutual funds compete for the institutional investor dollar with bank commingled funds that are regulated in very different ways by the various federal regulatory agencies. There is a need to reexamine the patterns of regulation over institutionally-oriented mutual funds and bank commingled funds and to make those patterns more consistent with each other and with investor needs for similar protection. The Staff, however, cannot possibly afford to divert its resources from day-to-day administration into long-range reform of the regulatory pattern, no matter how necessary that might be.

Most disturbing for the protection of investment company investors is the inability of the Commission to maintain a satisfactory cycle of investment company and investment adviser inspections. Despite the productivity gains noted above, the Commission projects that in Fiscal 1987, without regard to the effects of Gramm-Rudman-Hollings, its cycle of investment company inspections will not exceed one each 4.3 years or cover more than 15 percent of investment company assets during the inspections in Fiscal 1987. Thus, the Commission will at best keep pace with its Fiscal 1985 inspection rate of once every 4.3 years, as indicated in the statistics given in the 1985 Annual Report.[5]

---

[5] There is a discrepancy between the numbers given in the Commission's 1985 Annual Report and its Fiscal 1987 Budget Estimate to Congress. The Annual Report shows 2,458 active investment companies and 567 inspections in Fiscal 1985 -- a
(footnote continued)

This is so even though the Commission has reported that some form of remedial action was required in 85 percent of the investment company inspections performed during 1985. Some 94 of the inspections -- more than 15 percent of the 567 inspections performed -- revealed deficiencies serious enough for further investigation.

In my view, an inspection cycle for Fiscal Year 1987 of more than four years, which, as it does now, covers only 15 percent of total industry assets during annual inspections, is seriously inadequate for the protection of investors. The Commission in the past has not disagreed. In its 1975 Annual Report, the Commission noted that its objective was to inspect every registered investment company and investment adviser at least once every two years. It has not met this objective, and will not, unless its resources are substantially increased or supplemented in some other way.

The Commission's inspection record for investment companies, no matter how deficient, is a regulatory model compared to the cycle that it has been able to achieve for investment advisers. In 1985, the Commission reported that it could examine only 9 percent of the registered investment advisers. This means that

---

(footnote continued from previous page)
frequency rate for investment companies of once every 4.3 years. The Budget Estimate shows 2,210 investment companies and 567 inspections in Fiscal 1985 -- a frequency rate for investment companies of once every 3.9 years.

the average investment adviser, despite the sensitive nature of its fiduciary responsibilities, is inspected by the Commission Staff only once in every 10.7 years.[6]

The regulation of the investment management industry goes beyond disclosure to more substantive forms of regulation. This type of regulation was deemed necessary by Congress in 1940 because of the sensitive nature of the fiduciary responsibilities assumed by investment advisers and the conflicts of interest that are inherent in the investment management business. Regular periodic inspections of investment advisory operations is essential to maintain compliance with regulatory requirements. This simply cannot be accomplished without substantial additional resources.

It has been suggested that these resources can be obtained through legislation requiring all investment advisers to join a self-regulatory organization as broker-dealers are presently required to do. Despite my reservations about expanding the role of self-regulation, I endorse this proposal as long as the responsibilities of the self-regulatory organization are limited to the inspection of investment advisers and the reporting of results to the SEC. Moreover, I question whether there is a need to form a new organization for investment advisers. This function might readily be assigned to the National Association of

---

[6] There is also a discrepancy between the numbers shown for investment advisers in the Commission's 1985 Annual Report and its Fiscal 1987 Budget Estimate to Congress. The Annual Report shows 11,146 investment advisers and 1,039 inspections in Fiscal 1985 -- a frequency rate of once every 10.7 years. The Budget Estimate shows 9,083 investment advisers and 1,039 inspections in Fiscal 1985 -- a frequency rate of once every 8.7 years.

Securities Dealers, Inc. Action of this type, however, will not eliminate the need to augment SEC staffing for the effective regulation of the investment company industry. I urge that this Subcommittee not neglect this vital need.

E. The Need for New Legislation

By far the most important need of the SEC is additional resources to administer its existing regulatory authority rather than new regulatory authority. The Commission, however, deserves strong criticism for its failure to support and give strong leadership to the efforts of this Subcommittee and other members of Congress to enact legislation to regulate Government securities dealers. Such legislation is critically necessary to protect the growing number of investors in Government securities markets, markets which -- in an era of fluctuating interest rates -- have become increasingly volatile and dangerous, even for sophisticated investors.

Over the past several years we have witnessed the bankruptcies of several large Government securities dealers. We have seen the ripple effect on the financial community of those bankruptcies, leading to severe losses and hardship for thousands of depositors in savings and loan associations. These problems confirm that we can no longer tolerate the regulatory vacuum that has existed in the Government securities markets.

I find it difficult to explain or justify the failure of the Commission to support vigorously the enactment of Government securities dealer regulation that is at least as comprehensive as the regulation that applies to broker-dealers in corporate stocks and bonds. There is no reason to apply less regulation to Government securities dealers than to other broker-dealers. In my view, the SEC's failure to support meaningful legislation to regulate Government securities dealers has been inconsistent with the need to protect investors in such securities, as well as the entire financial community, from the unscrupulous and irresponsible elements that have been attracted to this regulatory vacuum.

F. The Role of Self-Regulation

The federal government budgetary pressures have led to suggestions for greater reliance on industry self-regulatory organizations, such as the National Association of Securities Dealers, Inc. and the various national securities exchanges, to regulate activities within the securities industry. In my opinion, industry self-regulation has earned an important place in securities regulation. For some functions, such as the regulation of trading activities on floors of national securities exchanges and in other trading systems, self-regulation can operate on a more informed, effective and prompt basis to curb manipulation and ensure fairness in our nation's securities markets. Moreover, as a practical matter, self-regulatory agencies can more effectively garner the resources necessary for comprehensive inspection programs of broker-dealers and investment advisers. For this reason, I support legislation that would direct the NASD or a new self-regulatory organization for the investment advisory industry to conduct inspections and impose remedial sanctions to the extent necessary to correct deficiencies and protect investors.

In my opinion, however, self-regulation is not a substitute for government regulation of the securities industry. There are several reasons for this position:

1. Self-regulatory organizations are controlled by industry members who are themselves the subjects of regulation. For this reason, self-regulatory organizations, while effective in curbing abuses among the marginal elements of an industry, cannot be expected to develop and enforce standards that may require modification or elimination of practices engaged in by even a mainstream minority of the industry.
2. Self-regulatory organizations do not have the power to subpoena evidence and to compel testimony from the general public. Accordingly, their investigative and disciplinary activities are limited to those cases where the available evidence can be obtained from member organizations and their employees. Many cases cannot be effectively investigated or prosecuted within these limitations.

3. Disciplinary actions of self-regulatory organizations are determined by committees of members who apply a businessmen's standard -- not a regulatory standard -- in making their judgments. The decisions of the businessmen serving on disciplinary action committees tend to vary greatly from committee to committee, and from region to region. There is less consistency to their decisions than to the decisions of a government regulator like the SEC, and there is a concomitant danger of great unfairness in that inconsistency.
4. Most important of all, the regulatory activities of self-regulatory organizations have a serious anti-competitive potential, making the exercise of authority by those organizations necessarily suspect. It requires constant vigilance to satisfy ourselves that self-regulatory organizations do not succumb to the anti-competitive mentality of the middle age guilds and use their regulatory authority to stifle, rather than to enhance, competition. For this reason, there is a danger in giving authority to regulatory agencies that goes beyond

regulation of trading and those other activities in which they can operate more effectively than the Commission.

It should be emphasized that increased reliance on self regulatory organizations is no panacea for the Commission's staff problems. The assignment of more responsibility to these organizations also would require the Commission to assign more personnel to oversight functions with respect to self regulatory activities in order to assure that its statutory obligations are fulfilled.

G. Conclusion

It seems clear to me, and I believe to many others outside the Commission who are most familiar with its activities, that a substantial increase in Commission resources is essential if the Commission is to maintain effective regulatory control over the securities industry that exists today. We also must look beyond today to the future. As you know, there are many well-respected analysts who are predicting that the stock markets will continue to rise until the Dow Jones Average reaches 3,000 -- perhaps as high as 5,000. No one knows, of course, whether these predictions are true, but we do know that if the market does rise, it will attract more and more persons to the securities markets and to the securities industry. These persons, whether they be investors or professionals, are likely to be less sophisticated, less knowledgeable, and more in need of protection and reglation than the existing investor and professional population.

If the Commission is going to be able -- even in a minimal way -- to cope with the substantial future increases in securities-related activities, it must begin now to build an adequate Staff. Such a building process cannot be accomplished overnight, and any attempt to do so would be wasteful in terms of resources and unproductive in terms of developing a properly trained, knowledgeable Staff. Accordingly, I urge that this Committee consider a long-term development program which would call for a 10 percent increase in the Commission Staff during fiscal 1987, and additional percentage increases of at least 40 percent more, in phases, over the next five or six years. Staff build-up should be constantly monitored in the light of current activity and developments to determine whether the Staff remains adequate to cope with the potential demands on its resources.

In making this suggestion, I am not unmindful of the grave problem of the federal deficit; nor am I unaware of the policies of the Gramm-Rudman-Hollings legislation. I do not suggest that increases in the Commission Staff such as I have suggested should be funded at the expense of deficit reduction. In the case of the Commission, the choice between adequate resources and deficit reduction is not necessary. As this Subcommittee knows, the Commission, through the collection of fees imposed on filings with it, in the last several years has more than covered its budgeted expenses. Indeed, in fiscal 1985, fees exceeded the budget by 35 percent, and the Commission gave $37 million more to the United States Treasury than it received from the Treasury. It is possible, therefore, to fund a 35 percent increase in the

Commission's budget with the existing level of fees it collects. SEC filing fees were never intended to be a source of revenue for the federal government beyond that necessary to finance Commission activities, and it would be consistent with budgetary policy to spend excess fees on the Commission's budget in order to provide resources necessary for an adequate program of securities regulation. If necessary to avoid interference with deficit reduction, however, an increase in those fees would be a small price to pay for an adequate SEC budget.

To provide for increased inspection of investment advisers, I also urge the Subcommittee to consider legislation designating the NASD as the self-regulatory organization for the investment advisory industry, or creating a new organization, and requiring that each registered investment adviser be a member of that organization. The functions of the NASD or other organization, however, should be be limited to inspections of investment advisory organizations, remedial action to correct deficiencies, and development of better industry compliance programs for the protection of the investing public.

Finally, I urge continuing efforts to pass strong regulatory legislation for Government securities dealers. As I have noted, there is no area more in need of effective industry regulation, and no reason why that regulation should be substantially different from the pattern of regulation established for broker-dealers in other types of securities.

INVESTMENT COMPANIES, INVESTMENT ADVISERS AND BROKER-DEALERS

	1975	1980	1984	1985
Investment Companies				
Number of Companies	1,399	1,507	2,210	2,458
Assets ($ billions)	74	150	370	525
Investment Advisers				
Number of Active Advisers	3,420	3,660	9,083	11,146
Assets Under Management ($ billions)	N/A	410	850	1,170
Broker/Dealers	3,546	5,102	10,414	11,404
Registered Representatives	72,000	76,781	N/A	357,000

Source: Securities and Exchange Commission Annual Reports for Fiscal 1975, 1980, 1984 and 1985.

60-665 0 - 86 - 7

ENFORCEMENT ACTIVITY

	1975	1980	1984	1985
Investor Complaints	9,500	N/A	30,646	31,221
Matters Under Inquiry Instituted	N/A	N/A	877	876
Investigations Instituted	490	322	341	339
Administrative Proceedings Instituted	142	74	114	122
Civil Litigation				
Cases Instituted	174	103	179	143
Defendants Named	N/A	N/A	508	385
Defendants Enjoined	749	387	N/A	N/A
Criminal Actions Referred to Justice Department	88	74	52	52

Source: Securities and Exchange Commission Budget Estimates for Fiscal 1977, 1982, 1986 and 1987; Annual Reports for Fiscal 1975, 1980, 1984 and 1985.

EXAMINATION OF 1933 ACT FILINGS

	1975	1980	1984	1985
1933 Act Registration Statements -- New Issuers				
Filed (%)	2,413	601	1,183	965
Reviewed[1]	2,648[2] (100%)	601 (100%)	923 (78.0%)	581 (60.2%)
Not Reviewed (%)	-----	---	260 (22.0%)	384 (39.8%)
1933 Act Registration Statements -- Repeat Issuers				
Filed (%)		900	3,300	3,670
Reviewed (%)		180 (20%)	970 (29.4%)	950 (25.9%)
Screened (%)[3]	(included with	720 (80%)	-	-
Monitored (%)[4]	new issuers)	-	576 (17.5%)	415 (11.3%)
Not reviewed, Screened or Monitored (%)		0	1,754 (53.1%)	2,305 (62.8%)

Source: Securities and Exchange Commission Budget Estimates for Fiscal 1977, 1982, 1986 and 1987.

---

[1] A "review" involves a thorough legal, financial and accounting examination of a filing.

[2] Includes statements pending at the beginning of Fiscal 1985.

[3] A "screening" involves a cursory check of a filing to determine whether a complete filing review is needed.

[4] A "monitoring" involves a directed review for specified disclosure in a document.

EXAMINATION OF 1934 ACT FILINGS

	1975	1980	1984	1985
Annual Reports (10-K's)				
Filed	9,564	8,344	9,374	9,847
Reviewed (%)[1]	11,013[2] (100%)	417 (5.0%)	1,283 (13.7%)	2,064 (21.0%)[3]
Monitored (%)[4]	N/A	-	2,986 (31.8%)	354 (3.6%)
Screened (%)[5]	N/A	1,752 (21.0%)	-	-
Not Reviewed, Screened, or Monitored (%)	0	6,175 (74.0%)	5,105 (54.5%)	7,358 (74.7%)
Quarterly & Current Reports				
Filed	44,018	28,540	35,724	39,044
Reviewed (%)	45,345 (100%)	3,187 (11.2%)	832 (2.3%)	1,955 (5.0%)
Monitored (%)	N/A	-	9,018 (25.2%)	9,728 (24.9%)
Screened (%)	N/A	5,688 (19.9%)		-
Not Reviewed, Screened or Monitored (%)	N/A	19,665 (68.9%)	25,874 (72.4%)	27,361 (70.1%)

---

[1] A "review" involves a thorough legal, financial and accounting examination of a filing.

[2] Includes reports pending at the beginning of Fiscal 1975.

[3] During Fiscal 1985, 71 annual reports were reviewed during a paid overtime project. Therefore, 2,135 (21.7%) were actually reviewed.

[4] A "monitoring" involves a directed review for specified disclosure in a document.

[5] A "screening" involves a cursory check of a filing to determine whether a complete filing review is needed.

Annual Meeting Proxies				
Filed	6,587	6,740	7,731	8,424
Reviewed	6,642[6] (100%)	1,348 (20.0%)	1,217 (15.7%)	1,683 (20.0%)
Monitored	-	-	72 (0.9%)	360 (4.3%)
Screened	-	5,392 (80.0%)	-	-
Not Reviewed, Screened or Monitored (%)	0	0	6,442 (83.3%)	6,381 (75.7%)
Tender Offer Filings				
Filed	N/A	104	387	532
Reviewed (%)	N/A	104 (100%)	261 (67.4%)	369 (69.4%)
Monitored (%)	N/A	0	25 (6.5%)	2 (0.4%)
Not Reviewed, or Monitored (%)	N/A	0	101 (26.1%)	161 (30.2%)

Source: Securities and Exchange Commission Budget Estimates for Fiscal 1977, 1982, 1986 and 1987.

---

[6] Includes reports pending at the beginning of Fiscal 1975.

EXAMINATION ACTIVITY

	1975	1980	1984	1985
Investment Companies				
Inspections Completed	245	241	497	567
Deficiency Letters Sent	N/A	147	277	316
Referrals to Enforcement	N/A	17	21	29
Inspection Cycle	5.71 yrs	6.25 yrs	4.43 yrs	4.33 yrs
Inspection Advisers				
Inspections Completed (%)	404	521	837	1,039
Deficiency Letters Sent	N/A	260	446	550
Referrals to Enforcement	N/A	36	59	65
Inspection Cycle	8.49 yrs	7.02 yrs	10.85 yrs	10.73 yrs
Broker-Dealer				
Oversight Examinations	N/A	178[1]	389	447
Oversight Examination Cycle	N/A	36.92 yrs	26.77 yrs	25.51 yrs
Cause Examinations	N/A	523	226	145

Source: Securities and Exchange Commission Budget Estimates for Fiscal 1977, 1982, 1986 and 1987; Annual Reports for Fiscal 1975, 1982, 1984 and 1985.

---

[1] Does not include 158 examinations of SECO broker/dealers.

Mr. **Wirth**. Thank you very much, Mr. Phillips.

We have heard from NASAA and from the American Bar Association's chairman, speaking on his own behalf; a couple of very, very strong statements in which Mr. Griffin, if I can paraphrase, said we face the real possibility of serious securities fraud in this country. And Mr. Phillips, in 25 years you have never been more concerned about the ability of the Commission to promote disclosure and enforce the SEC laws.

I will come back to Mr. Shad, with a question as to his comments on those two, I think, very, very strong statements.

Let me go, if I might, further on your statement, Mr. Griffin. You said we are in the midst of an epidemic of securities fraud.

I want to ask you, Mr. Phillips, are our problems today worse than they were 10 years ago, and how do we measure that. We have heard a lot of people accurately saying that investors are pouring money into the stock market, so they must have confidence that something is working right.

I am not suggesting that we should not look for ways to improve our system of securities regulation, but does not the broad participation of so many investors in our market today, tell us that the SEC and the SRO's and the States together are doing a pretty good job.

Mr. **Phillips**. I think that investor participation in the markets is a reflection of confidence in the economy and not necessarily that the SEC is doing a good job and there is no fraud. I do not necessarily subscribe to phrases like, "an epidemic of fraud;" on the other hand, I don't think that there is less fraud than there has ever been.

When volume has increased 700 percent, when the number of securities salesmen has increased 500 percent, and there is a decline in SEC enforcement activity, one cannot but question whether, in fact, the SEC is coping effectively with the level of fraudulent activity in the marketplace. I don't believe they have, unless one assumes that there is less fraud than ever before, and I do not think there is any evidence to that effect.

Mr. **Wirth**. Mr. Griffin.

Mr. **Griffin**. Mr. Chairman, I think the evidence of fraud in the marketplace is all around us, but I would point out that the marketplace is larger, perhaps, than the universe that this committee or even the American public in general thinks of when they think of securities. That marketplace includes an enormous number of off-exchange traded exotic securities opportunities, an area from which the SEC, because of budget cuts, has been forced to almost entirely withdraw from.

Tax shelters is another area that the SEC doesn't have the resources to police. The low end of the securities market is another. I was speaking to a reporter for Money magazine yesterday. Of the last 100 or so offerings that went public for less than $5, a considerable majority of those were blind pools, companies that don't state a business plan of any sort or any sort of operational guide as to what they plan to engage in.

The problem is with us. It is quite clear. I think that the fact that the stock market, the Dow Jones industrial average is higher than it has ever been before is reflective, as the gentleman from the bar suggested, of great confidence in the national economy, in the future of the national economy.

I would point out to you, however, that the percentages of individual investors, people like you and I, in the marketplace is steadily declining. People are afraid to compete in the stock market. They would prefer to have the protection of institutions, mutual funds, whatever, to compete with the big boys, as they imagine.

Whether it is true or not, there is the perception that insiders have a lot of advantages in the stock market that the private investor, the private citizen, does not have. For that reason, even though the Dow is higher than it has ever been before, I would suggest that participation of individual investors is what you should look at and that that is not as high as it should be.

Mr. **Wirth**. Mr. Schultz.

Mr. **Schultz**. Your question seeks to discern the level of fraudulent activity in general, I take it, and the SEC's efforts to address that level. It is difficult to measure precisely the level of fraud. These gentlemen may have a greater feeling than I do in general. However, the Commission itself, of course, uses various activity measures as indicators of fraud and of course those activity measures are going up.

As you may know, we are looking specifically at the enforcement program of the Securities and Exchange Commission pursuant to a request by Chairman Dingell, and we would be prepared to report the results on their enforcement activities at a later date. We did do a preliminary report last year on that matter.

Mr. **Wirth**. When do you expect that report?

Mr. **Schultz**. We anticipate by the end of this calendar year, sir.

Mr. **Wirth**. Thank you all.

Mr. Luken.

Mr. **Luken**. Thank you, Mr. Chairman.

What strikes me is the information contained in Mr. Phillips' statement on page 2, and that is, what I would like to ask is: What are the responses? What justification is there for the situation where injunctive actions and administrative proceedings instituted by the Commission have declined from 316 in 1975 to 265 in 1985, in the face of the fact that in 1985 the total number of respondents named in both injunctive actions and administrative proceedings were only 584, while in 1975 the Commission enjoined 749 persons, in comparison: In 1985, 584; in 1975, 749. And then the decline in enforcement activity took place notwithstanding a tripling of investor complaints in 1985 from those received in 1975.

It would seem to be that those statements form a closed circle and that there doesn't seem to be any possible response. What is the response that you have heard as to why this falling off of enforcement?

Mr. **Phillips**. There is one thing to say in defense of the Commission and its staff. In terms of the individuals named, they have been more careful in recent years in investigating cases and making sure that the evidence is sufficient to support a charge against the individuals. That may explain some of the decline in the number of individuals named.

On the other hand, I do not think that there is any explanation other than inadequate staff to explain the fact that with the huge increases in every indicia of activity, there is less, not more, enforcement activity. One would have expected at least a doubling, if not a tripling of enforcement activity during this period. The fact that there has been a decline, in my view, is attributable to one factor and one factor alone: no manpower. There is no technology that can substitute for manpower when it comes to conducting an investigation and enforcing the securities laws, and the Commission doesn't have manpower.

Mr. LUKEN. Any other comments on that point? Would your response be the same?

Mr. GRIFFIN. I would associate myself with those remarks. It's simply a matter of there are more crooks and fewer police.

Mr. LUKEN. You know, when we were here on the savings and loan crisis, which had reverberations internationally, it certainly shook the confidence in our financial institutions in this country. It cost the taxpayers of Ohio at least $130 million already. I am comparing, now, some dollars of enforcement versus what the costs are of lack of enforcement, just one little aspect, just in Ohio, just the appropriation of the State legislature to bail out another situation in Ohio, where the savings and loan supertintendent's office was obviously and totally inadequate to inspect, and therefore they did not blow the whistle when they knew the facts were before them.

As a matter of fact, and this is something I want to point out, the information upon which these gentlemen have been indicted in Ohio, just by setting forth the information, not charging fraud or anything like that, but just setting forth the information and saying that that constituted a misapplication of funds, criminal misapplication, was in the 10K's of the Home State Savings and Loan filed with the SEC for more than 1 year, 1982, I believe, 1983, I believe also 198'.

The information of the overcollateralization—in other words, the risking of depositors' funds—was in the 10K's. Now, you are saying that those 10K's are not being reviewed today; is that right?

Mr. PHILLIPS. I am saying they are being reviewed on a cycle of once every 5 years and that is inadequate.

Mr. LUKEN. Whereas in the past they have all been reviewed. And whether or not a review would have led to enforcement, we hope that it would. I mean we are in a kind of who-shot-John kind of a thing now as to the communication between the Federal Home Loan Bank Board and the Ohio superintendent. The Federal Home Loan Bank Board came in here with an excuse, blaming it on the Ohio authorities recently for not communicating with them. But the facts that brought down these savings and loans and caused all of that crisis which is all well known were in the papers that had been filed with the various regulatory authorities.

So I think your point is well made that we should be concerned about the larger issues. We are not cutting back on the IRS today because of Gramm-Rudman. We are not cutting back on Customs today because of Gramm-Rudman. I hope we are not. And I hope we don't cut back on the FBI. But particularly—we probably are, but I hope we are not going to eventually.

But with reference to these law enforcement bodies which produce revenue, actually, they save revenue, and this law enforcement or this enforcement agency will save the investor, save the consumer, save the public far more than the dollars that we are talking about in cutting back in allowing more depredations, more violations to go unpunished.

Thank you, Mr. Chairman.

Mr. Wirth. Thank you very much.

Mr. Rinaldo.

Mr. Rinaldo. Thank you, Mr. Chairman.

As I looked over the testimony, I noticed that Mr. Phillips called for greatly expanded resources of the SEC in the areas of enforcement, full disclosure, and investment management. I would like to know where the funding for this greatly increased spending is to come from.

Mr. Phillips. As I explained in my statement, Mr. Rinaldo, it should come not from the Federal Treasury but from the fees collected by the SEC.

Mr. Rinaldo. But the fees, you have to recognize, are part of the Federal Treasury. Right now that is the situation, just like bank regulatory agencies collect fees and it all goes into the General Treasury. You are proposing changing the whole system around at a time when we are faced with severe fiscal constraints, when Gramm-Rudman presumably will trigger into effect unless we come up with a budget to meet the mandate that is stated in that legislation that the deficit can't exceed $144 billion.

If we do what you propose, by taking revenues out that are already counted on to become part of general revenues, then we won't be able to fulfill that mandate.

Mr. Phillips. I don't think that is a correct perception of my statement, Mr. Congressman.

Mr. Rinaldo. Then you give me the correct perception.

Mr. Phillips. Yes; what I suggested was that since the SEC returned 35 percent more of its budget than it received, it would be unfair to take those fees and finance a more effective SEC, but I also suggested that not withstanding unfairness to those who may pay the fees, it is so critically important to augment the resources of the SEC that I would support an increase in fees that would do the financing without any impact whatsoever on the Federal deficit.

I think it is a small price to pay for an effective SEC, not only to protect investors but to protect the small savers in the Ohio savings and loan associations, and in Maryland, and throughout the country.

Mr. Rinaldo. You recognize that any increase in fees would be predicated upon this Congress passing legislation to increase fees, and I think you also should recognize the fact that the President has stated over and over again that any increase in fees, new taxes, any type of revenue enhancement would be vetoed upon arrival on his desk.

So I don't think it is a realistic basis upon which to say that we can obtain additional funding.

Mr. Luken. Would the gentleman yield?

Mr. Rinaldo. Not at this point; I'm questioning the witness on a statement in which he disagrees with my position. He is stating that he is going to change a whole system around; and I'm telling him that it's very, very difficult to do that. You are saying you are going to increase fees. Are you then going to use just the increase for this additional enforcement? Or are you going to use what we already anticipate collecting and which every budget proposal that comes down the pike includes in there as part of the general revenues expected to be part of general revenues?

Mr. **Phillips**. I would increase the fees enough to support an effective SEC, so that there would be no impact on the Federal budget, and I don't think that an increase in fees is changing the system around.

Mr. **Rinaldo**. All right; you propose increasing the fees and using the increase in fees to support more effective enforcement. How much of an increase do you propose?

Mr. **Phillips**. Enough so that over a period of 5 or 6 years, the SEC staff can be increased by at least 50-percent. I do not think the SEC staff was built overnight and I don't think you can increase it overnight very effectively, but over a period of 5 years, I would seek at least a 50-percent increase, and if necessary for Federal budgetary purposes, increase fees by an amount sufficient to fund that increase.

Mr. **Rinaldo**. What amount would that be?

Mr. **Phillips**. I'm sorry, Mr. Rinaldo, I have not done the calculations, but perhaps the Commission with its budgetary experts can give you those numbers.

Mr. **Rinaldo**. And how fast do you think such a bill could be introduced, get through committee hearings, get through both Houses of Congress and get to the President's desk, where it would await an uncertain fate?

Mr. **Phillips**. I would never underestimate the effectiveness of Congressmen like you in getting legislative action when you think something is important, and I'm trying to convince you that it is indeed important.

Mr. **Rinaldo**. Well, I'm trying to convince you that it changes the system.

Let me ask you another question along the same lines. On page 6 of your testimony you state that the SEC is increasing its referral of complaints to the States and the SRO's. Is that an appropriate and effective development, in your opinion, or is that an inappropriate development? Is there something wrong with that?

Mr. **Phillips**. It is neither wholly inappropriate nor wholly appropriate. There are several considerations. The States have limited resources. So do the SRO's. The SEC is making these referrals and it does not have a system in effect that allows it to determine whether, in fact, the agency to which it is referred has taken any action.

Second, there are severe limitations on the jurisdictional authority of both the States and the SRO's. What might seem to be a local complaint involving a local broker-dealer may, in fact, be the first indication to a regulatory authority of a nationwide problem.

It is my understanding based on my experience that the SEC is referring complaints that may be symptomatic of more thoroughgoing nationwide fraud and other problems, and to that extent, it is inappropriate.

Mr. **Rinaldo**. If I recall correctly, GAO in their report stated that the SEC was doing a good job when it comes to making referrals. Are you advocating the concept of the SEC, the States, and the SRO's formally dividing up certain areas of responsibilities?

Is that what you re saying.

Mr. **Phillips**. I'm sorry, Mr. Rinaldo.

Mr. **Rinaldo**. What I said is, are you advocating the SEC, the States, and the SRO's formally dividing up their areas of responsibilities?

You said, in effect, that the SEC—correct me, if I'm wrong—is referring cases to the States that shouldn't be referred.

Mr. **Phillips**. That's correct.

Mr. **Rinaldo**. Do you have specific examples of those cases?

Mr. **Phillips**. Yes; I have an example. For example——

Mr. **Rinaldo**. How many examples do you have?

Mr. **Phillips**. Oh, I don't have many examples. I'm not in a position to be on the receiving end of 31,000 complaints. I'm just a lawyer in private practice. I like to think I'm as informed as any lawyer, but I don't have the ability to give you a broad perspective on how the SEC handles complaints.

But I will tell you something, Congressman, they don't know how they handle them.

Mr. **Rinaldo**. Just a minute, Mr. Phillips. When you make a charge such as you just made in front of a committee of Congress, I would hope that you would have the facts and the evidence to substantiate the indictment that you're making. And apparently you don't, because you're telling me that you don't have any examples. You don't know how many cases. I would have hoped you would have come here better prepared, so that we could understand whether or not the SEC was actually derelict in their duty. And if so, I would like the evidence put on the table, so that then we could take the fast, appropriate, effective action that you said that I'm very capable of taking.

Mr. **Phillips**. It is my understanding, Mr. Congressman, that the SEC also does not have the information that would tell it or you whether the complaints they have referred to the States or to the SRO have, in fact, been acted upon effectively. If the SEC doesn't keep and publish the statistics, those outside the SEC simply don't have the ability to gather that information and to analyze it.

I have tried in my testimony, in other areas where there are statistics, to furnish this committee the facts and the analysis, and I think it demonstrates that there are inadequate inspections, inadequate examinations of Commission filings—the areas where the SEC has published statistics.

Mr. **Rinaldo**. But in this particular instance, without the facts, then I don't think we can infer that your conclusions are accurate.

Mr. **Phillips**. I think you can—you have a right, as a committee, to ask that the SEC, as the agency referring investor complaints, have a capacity to know whether those complaints are being handled effectively. I don't think they have a system. I don't think they know. And that's my understanding of the fact.

Mr. **Rinaldo**. My time is up. But in other words, what you're stating is that is your opinion, based upon your general knowledge, exclusive of any facts, and without any specific examples that you can set forth here today.

Thank you.

Mr. **Wirth**. Thank you, Mr. Rinaldo. Mr. Tauzin.

Mr. **Tauzin**. Thank you, Mr. Chairman.

Mr. Phillips, just a couple of weeks ago, there was delivered upon my desk here in Washington a document entitled "The Budget of the United States of America," "The Executive Budget of the United States of America," prepared by the President of the United States as a recommendation to this Congress. It was declared by most observers, including the Republicans in the Senate, to be dead on arrival.

But members of my staff and I did a brief autopsy on the body of that budget, and we discovered some interesting things, a thing called user fees for FHA, for VA, for the Coast Guard, for the Corps of Engineers, apparently a wide array of user fees recommended by the administration under the theory that those who receive benefits from a Federal agency ought to pay for those benefits.

I hear you recommending the same thing, and although my good friend from New Jersey has indicated that he didn't think Mr. Reagan would approve of a user fee, it seems to me that the President is recommending a wide array of them, and what you are recommending to us is simply another example where the securities industry, which should receive the benefit of proper regulation and who may not be receiving that benefit today, might be willing to pay additional user fees, if, in fact, they're not going to go to some other worthwhile Government project, but rather to the purpose intended, which is proper regulation by the SEC.

Is that your position?

Mr. **Phillips**. That's correct.

Mr. **Tauzin**. It sounds like an eminently correct one and one that the administration would probably endorse, from my reading of its budget.

What alarms me, besides the statistics you've been able to produce about the tripling of complaints and the lessening of enforcement activity, which I hope we'll have a chance to get into with some of the agency representatives before we're through today, is the fact that there continues to be, in the whole of the discussion today, a dispute over those statistics and over the enforcement facts.

That alarms me, particularly when, Mr. Griffin, you recommend something that this committee, I think, should pay close attention to. On page 1 of your summary, you indicate that the SEC's statutory authority might need to be enhanced in one critical area, and that is its ability to provide information with reference to its enforcement activities to people like Mr. Phillips, who are interested enough to come to our committee and make recommendations to us.

You say, for example, that in some instances, you have been told to file Freedom of Information Act requests to get information on enforcement activities. Would you describe for me what instances those involve, as maybe differentiated from other instances where you've been able to obtain information?

Mr. **Griffin**. My understanding is that once a formal order of investigation has been entered by the Commission, it is impossible, virtually impossible, for other law enforcement agencies or regulatory bodies to get access to that information.

In other cases, particularly in reference to some corporate finance issues, we have been requested to file Freedom of Information Act requests. The States have, in fact, on a number of occasions in the last several years, been asked to file Freedom of Information Act requests.

Mr. **TAUZIN**. Have you had any difficulty, any of you on this panel, in obtaining statistical information on enforcement activities from the agency?

Mr. **GRIFFIN**. Congressman, I quite frankly believe that that information doesn't exist. People constantly ask, how much fraud is there in Colorado; how much fraud is there in California.

I have no idea, and I think that's an unknowable number. I think we can get some indication, such as the number of complaints filed with a particular agency. But you have to realize that there is an awful lot of hidden fraud going on. People don't complain on many occasions because they're ashamed of having made a serious mistake with their money.

Mr. **TAUZIN**. You make several other, I think, excellent recommendations. One is in reference to the SEC's apparent lack of legislative authority to deny registration to those persons convicted of serious crimes that might indeed indicate some propensity toward fraud, particularly drug smuggling and dealing and those types of individuals. While they can be denied a liquor permit, they apparently can't be denied a registration to become a broker-dealer; is that correct?

Mr. **GRIFFIN**. My understanding is that the National Association of Securities Dealers only has the power to exclude a person if they are convicted of some crime involving defalcation of funds, embezzlement, securities fraud; things of that nature.

Now I would agree that there are some kinds of crimes that probably shouldn't exclude a person from the industry. But drug importation, I think, probably is not one of those categories.

Mr. **TAUZIN**. What you're saying is that perhaps we ought to broaden the categories.

Mr. **GRIFFIN**. That's correct.

Mr. **TAUZIN**. You also recommend that the Commission be empowered to issue cease-and-desist orders directly, rather than going to court.

Would you elaborate a bit on that.

Mr. **GRIFFIN**. One of the tools that the States use most effectively is the administrative cease-and-desist authority. It is an administrative order directed at an individual or a business enterprise, ordering that individual or business enterprise to cease violating the law. It doesn't put them out of business; it simply says: "Stop violating the law."

The advantage to this is, if there's a subsequent violation, you have virtual open-and-shut proof of intent for criminal prosecution, because they've been subject to an order. You can also criminalize the violation of the order through the contempt proceedings that the committee is aware of.

Mr. TAUZIN. Now, Mr. Griffin, how does the lack of authority of the SEC to issue these cease-and-desist orders compare with other regulatory agencies?

Mr. GRIFFIN. Some 35 States have that authority. I am not that familiar with Federal practice to know which administrative agencies have it and which don't.

I think it's clear that, for instance, in the banking context, the Bank Board can close a bank. The SEC lacks that authority and needs to go to court in every instance to make its case. I suggest that's an extremely expensive form of remedy.

Mr. TAUZIN. You also mentioned that the SEC should be required to examine the impact of its regulations that have been implemented, and you mentioned one that has a lot of sensitivity to those of us who represent areas with high unemployment, and that is regulation D, which is supposed to be used as a tool for job creation and small businesses, in particular.

Would you elaborate a bit on that regulation, and what do you think the SEC's activities here have either achieved or lacked?

Mr. GRIFFIN. The States, I think, with a good deal of unanimity, have serious problems with regulation D, as it's been implemented, interpreted, and the effects that the regulation——

Mr. TAUZIN. For the record, would you describe the regulation?

Mr. GRIFFIN. Regulation D replaced a number of other exemptions in the Federal regulatory scheme. It is basically—it was purported to be to encourage the development of capital for small businesses. It has three parts: rules 504, 505, and 506. I won't go into detail as to what each of those are.

Suffice it to say that a substantial portion of the funds that have been raised under regulation D have been for tax-sheltered investments, rather than for equity investments that produce jobs, as we understand it.

That may or may not be Congress' wish for that kind of regulation, but the growth of tax shelters under regulation D has been astronomical compared to previous regulations.

Other parts of the regulation, rule 504, which was intended for really small business, under $500,000 in capital being raised, has had drastic, unintended effects in the creation of shell corporations in those States that don't do merit regulation, and shell corporations which essentially are designed to simply avoid Federal securities laws. These corporations are vehicles for mergers, and the only purpose in creating such a corporation under rule 504 is to avoid registering a second corporation that wishes to merge into it under the Federal securities laws.

Mr. TAUZIN. Now we've bumped into that in other hearings, Mr. Griffin.

So, in essence, you're saying that that part of the regulation, which should be supervised carefully as a job-creation type of vehicle, is instead being allowed to be used as a tex shelter, non-job-creation-type instrument.

Mr. GRIFFIN. They're being used for tax shelters and actually as vehicles for outright fraud in some cases under regulation 504.

Mr. TAUZIN. And then in the second case, the outright fraud, which is avoidance of other security laws designed to regulate mergers in this country, which have proved to be some real problem for us on this committee, so that what you're saying is that the SEC seems to have been woefully inadequate in following up on the implementation of this regulation?

Mr. GRIFFIN. Well, we applaud the idea of making capital available to small business. I mean, the association is strongly on record to that effect. However, we believe that if deregulation is to occur at the pace that it has occurred in the past, that some attention should be paid to the side effects of that deregulation.

I'm not certain that Congress intended regulation D to be a tax-shelter vehicle. I'm certain that it didn't intend it to create shell corporations, and I think probably the SEC didn't either.

Mr. TAUZIN. I thank you very much for your testimony, all of you, and yield back the balance of my time.

Mr. WIRTH. Thank you very much, Mr. Tauzin. Mr. Bliley.

Mr. BLILEY. Thank you, Mr. Chairman.

Mr. Griffin, to what extent can State regulators and SRO's do more to attain adequate monitoring and policing of the securities market.

Mr. GRIFFIN. To what extent can State regulators and SRO's do more?

Mr. BLILEY. Yes.

Mr. GRIFFIN. Is that the question?

Mr. BLILEY. Yes.

Mr. GRIFFIN. The State regulators are in a finger-in-the-dike situation. It was described recently by a legislator in my State as the States and the SEC with their thumbs in the dike and the water pouring over their heads all around them.

We have in Colorado, for example, over 280 open cases. We can resolve, with our staff levels, approximately 40 of those a year. The States are overwhelmed by that portion of the securities markets which no longer receive attention from the SEC—that is, the exotic markets, the partnerships, those kinds of securities that don't receive the kind of attention from the enforcement section that insider trading and market-manipulation-type cases do.

The States are more than willing to do anything that they can to solve this problem. We are currently engaged in cooperative efforts with the SEC. We want to increase the number of those. We would like to see the SEC have increased statutory authority to share information, to cooperate on every level, perhaps like the CFTC does, for example, in pursuing joint litigation under 6(d) of the Commodities Futures Act, where the States and the Federal Government can jointly pursue violators and share our resources.

If there is not going to be any increase in staff at the SEC, I think it is essential that we maximize the cooperation between the jurisdictions.

Now as to the SRO's, I think they need a clear mandate that they are representing the people of this country and not the industry that pays their salaries. It is essential that sales practices be more closely monitored and that that be mandated by the SEC with some teeth.

Mr. BLILEY. What is the size of your staff?

Mr. GRIFFIN. We have the monstrous size of 12.

Mr. BLILEY. Twelve. And has that changed in the last 10 years?

Mr. GRIFFIN. Up from 8½ in the last 5 years.

Mr. **Bliley.** Eight and a half to twelve. Do the fees that the State of Colorado charges cover the expenses of your office?

Mr. **Griffin.** We are truly cash funded. Our fees change every year. Our fees are set to match the amount of the appropriation. There is a separate fund established for securities. It doesn't impact on the general fund one way or the other.

Mr. **Bliley.** So then you could expand it?

Mr. **Griffin.** No; I'm sorry. It has to be appropriated—the legislature could expand it.

Mr. **Bliley.** That's what I meant.

Mr. **Griffin.** That is correct.

Mr. **Bliley.** And they would, I assume then, expand the fees to do it.

Mr. **Griffin.** The testimony that we receive in the legislature every year when we attempt to do this is that there is Federal jurisdiction; let the SEC do it. If the SEC staff——

Mr. **Bliley.** We hear that record frequently up here. Maybe that's why we have a $200 billion deficit.

Mr. **Griffin.** If the SEC staff is to be cut, then I think that somebody, the President perhaps, should send a letter to every State legislature and say: "The ball is in your court now, guys."

Mr. **Bliley.** I assume Colorado's budget is balanced.

Mr. **Griffin.** I think it is; yes.

Mr. **Bliley.** I see. So, in effect, we are asked to do more, but they don't want to do it themselves.

Mr. **Griffin.** I think there's a general feeling among people, citizens and legislators, that regulation of the national securities markets is primarily a Federal responsibility, and that for that reason, they look to Congress to appropriate sufficient funds to get the job done.

Mr. **Bliley.** Well, apparently at some point and some time, though, the people of Colorado felt that they needed one of their own, and so they have one.

Mr. **Griffin.** That's correct.

Mr. **Bliley.** If you followed your argument to its logical conclusion, then they would retire or RIF all of the people in Colorado and just say: "We're going to get out of it and leave it all up to the SEC."

Mr. **Griffin.** That's been suggested by more than one legislator, I might add.

Mr. **Bliley.** I would imagine. Fortunately, I guess, it hasn't been acted on, since you say there are enough who felt the other way, who have expanded your operation from 8½ to 12.

Mr. **Griffin.** That's correct.

Mr. **Bliley.** Almost 50 percent.

What is your own opinion of the advisability of using informants to help detect securities violations?

Mr. **Griffin.** In my opinion, not speaking for the association, is that if we are going to use informants in law enforcement, that we might as well use them in white-collar crime where they are most useful as in any other area.

I have serious philosophical problems with the use of informants at all. But if it is Federal policy to use them, this is a good area in which to do it.

Mr. **Bliley**. Do you think this would have a chilling effect on necessary communication?

Mr. **Griffin**. I have not really examined that issue. I suppose it could have some modest chilling effect. But I think the benefits probably would outweigh the disadvantages.

Mr. **Bliley**. Thank you, Mr. Griffin. Mr. Phillips, on page 7 of your testimony you are critical of the Commission's nonparticipation in recent hostile tender takeover battles. What facts can you cite to show that these tender offers, in fact, necessitated enforcement action by the Commission?

Mr. **Phillips**. The area of tender offers is regulated by the Commission under the Williams Act. In any tender offer battle there are questions raised by each side against the other as whether there has been compliance with the requirements of the Williams Act.

These issues are resolved, to the extent they are resolved, by the parties to the tender offers in the various Federal courts. The issues arise frequently. The parties battle it out by themselves, and the Commission is largely a bystander in that process.

I do not quarrel with the Commission's nonparticipation in this area, given their resources, their limited resources, and the fact that there are private parties who have an interest in compliance in this area.

But it seems to me that there are court decisions that vitally affect the application of the tender offer rules and that, in a limited number of cases, at least, the Commission should be in a position to become a very active participant. Today, with its resources, it cannot be.

Mr. **Bliley**. You say you do not quarrel with it because of—their abdication because——

Mr. **Phillips**. I think it is an intelligent allocation of priorities, given the limited resources.

Mr. **Bliley**. Well, let me read from page 8 of your testimony:

> The Commission's abandonment of participation in this area, however, has reduced the perception of the Commission as referee and enforcer of tender offer rules to that of a bystander and paper tiger. It is a perception that if left undisturbed can seriously undermine the credibility of the Commission and the enforcement of the securities laws.

And you say though that you agree that they should not do this.

Mr. **Phillips**. No; I said that given the limited resources, they really have no practical alternative but to forgo this area. But I do say that they need additional resources so that the problem described in my testimony does not continue without remedy. It is a problem and one that should be attended to.

Mr. **Bliley**. One further question, if I may. Are you aware of any substantial complaints that were filed at, and were ignored by the Commission?

Mr. **Phillips**. I think that there are substantial complaints issues in a large number of tender offers.

Mr. **Bliley**. That is not my question. My question is, Are you aware of any complaints that were filed at the Commission and were ignored by the Commission?

Mr. **Phillips**. I am generally aware, but I cannot give you a specific example, because I have not had occasion to file such a complaint. But that is my understanding in discussions with other members of the bar who are active in this area.

Mr. BLILEY. Well, that is hearsay, is it not?

Mr. PHILLIPS. It certainly is. Yes; it is. It is based upon conversations with others. It is not personal experience.

Mr. BLILEY. I see. Thank you, Mr. Chairman.

Mr. WIRTH. Thank you very much, Mr. Bliley. Mr. Nielson.

Mr. NIELSON. Thank you, Mr. Chairman.

I would like to ask Mr. Schultz a question since you have been ignored a little bit.

Mr. SCHULTZ. That is all right, sir, thank you.

Mr. NIELSON. Page 2 of your testimony, you state, "The Commission achieves important oversight objectives through its monitoring of the SRO's." Is that another way of saying the system is working fairly well?

Mr. SCHULTZ. If you mean the system to be the overall securities markets, certainly the general level of the Dow Jones would indicate that a lot of people have confidence in it.

Mr. NIELSON. That monitoring SRO's is working fairly well. Would you agree there may be some room for improvement, but signs are positive in that regard?

Mr. SCHULTZ. What we concluded was the SEC is achieving some very important objectives in its market oversight program.

Mr. NIELSON. And the signs are positive for effective regulation of SRO's then?

Mr. SCHULTZ. I think, as we pointed out——

Mr. NIELSON. Self-regulation, I should say.

Mr. SCHULTZ [continuing]. There are some concerns about the continued ability for the Commission to——

Mr. NIELSON. Overall.

Mr. SCHULTZ. Overall, things have been working well in the past; yes, sir.

Mr. NIELSON. OK. What is your assessment of SEC's effort to encourage development of SRO audit trails?

Mr. SCHULTZ. We have not done a specific review of the audit trails themselves. The staff has told us that they are, in fact, very happy with that progress.

Mr. NIELSON. Which staff has told you that?

Mr. SCHULTZ. The SEC staff, sir.

Mr. NIELSON. And do you concur with that, or you just did not look at that?

Mr. SCHULTZ. We have not made an examination of that ourselves.

Mr. NIELSON. OK. On page 5 you mention that the inherent tension involved in industry professionals regulating themselves—based on your work, do you have any evidence that this tension really hinders the SEC regulations?

Mr. SCHULTZ. The tension is simply the give and take in the regulation, and the interaction between the industry and the SEC. It is exemplified by the fact that they prefer a negotiating process to working out problems they find at SRO's, for example.

Mr. NIELSON. Is this give and take approach of SEC pretty effective in your view?

Mr. **Schultz**. We found that in the instances that we looked at, most of the problems the SEC found were, in fact, eventually taken care of and resolved.

Mr. **Nielson**. Since you are from GAO, let me follow up on a question that Mr. Rinaldo asked earlier.

Mr. Phillips recommends increasing fees, and yet we have fees 35 percent more than we use in that area. Would increasing the fees, as Mr. Phillips suggests, would that decrease the budget deficit in your view. Would it actually help solve the budget deficit problem?

Mr. **Schultz**. I am not prepared, I am sorry, to talk about increasing fees.

Mr. **Nielson**. GAO is prepared on all financial matters, is it not?

Mr. **Schultz**. Various parts of GAO are; yes, sir.

Mr. **Nielson**. We rely very heavily on you in that. Mr. Tauzin seemed to feel that that was a user fee, and if they are paying 35 percent more than the cost right now, what is the justification on the basis of user fee?

Mr. **Schultz**. I think the point of the discussion is that it is necessary to prioritize whatever we want government to spend on, or what we want to collect fees for. I think the case that these other gentlemen—if I can paraphrase them—are trying to make is that this is something on which we are to place some priority on spending something.

Mr. **Nielson**. Well, I would agree. But I think it should be frontal attack on the budget itself. SEC, a budget they can use. The user fees are already exceeding the services that they can possibly get. And so I think it might be inappropriate to increase fees that are already too high.

Let me ask Mr. Phillips a question. On page 3 you suggest that the SEC's productivity increases that they claim are misleading, statistics showing them are misleading. Do you have any hard evidence of this assertion that their statistics are misleading?

Mr. **Phillips**. No; I did not mean to suggest that the statistics were misleading. I do not think I used that phrase. But I did mean——

Mr. **Nielson**. You said, "statistics showing productivity increases can be misleading."

Mr. **Phillips**. Can be misleading.

Mr. **Nielson**. But you do not have any evidence that they are?

Mr. **Phillips**. No; but what I am trying to say is, you cannot judge the effectiveness of an enforcement activity simply by looking at statistics. You have got to look at the kind of cases, for example.

Mr. **Nielson**. To tell a statistics professor that statistics are misleading, I would like to know wherein they are misleading.

Mr. **Phillips**. OK, let me give you an example.

Mr. **Nielson**. I am aware of the——

Mr. **Phillips**. Let me give you an example.

Mr. **Nielson**. All right.

Mr. **Phillips**. Last year the SEC showed more enforcement actions than this year. They pointed out, however, this year that a large number of those enforcement actions, or a good percentage of the decrease, consisted of cases brought to enforce section 16(a), the insider reporting provisions.

In my experience—and I have had personal experience with that kind of case—it generally is a very simple case. I say, generally, very simple cases to investigate and prosecute. In most of those cases there is very little witness testimony. Enforcement statistics that have a large number of those cases, not show any increase in productivity.

Mr. NIELSON. Do you have any specifics to indicate these statistics are wrong?

Mr. PHILLIPS. No; but I am suggesting that you have to be wary of them. I just said they can be misleading.

Mr. NIELSON. We all agree that you have to——

Mr. PHILLIPS. No, no; I do not for a minute suggest that the SEC has put out wrong statistics.

Mr. NIELSON. It is good to be wary of numbers, but it is even better to be wary of assertions not backed by any evidence.

May I suggest another question. On page—you mentioned that the Commission should inspect and can inspect every 4 years. In 1975 the Commission said its goal was to inspect every 2 years. Do you know any commission of this or any other agency that can go over all of its records every 2 years. Is that turnaround time—is that a reasonable goal?

Mr. PHILLIPS. I think that is a reasonable goal. I think that is a necessary goal to inspect investment companies every 2 years, yes; I do.

Mr. NIELSON. And since they only do it every 10 years according to your own numbers, that would increase their staff by a factor of five; is that correct?

Mr. PHILLIPS. No; I think we are talking about two different entities.

Mr. NIELSON. No; let us stay with this number. You said, they only have staff—a 10-year turnaround right now; every 10 years is the way they are doing it at the present rate. It should be every 2 years. Does that not——

Mr. PHILLIPS. No; I was talking, I think, in that part of the statement, Mr. Nielson, about investment company, not investment advisor inspections. Today they inspect investment companies every 4 years. But in 1975 the Commission announced a goal of inspecting every 2 years.

Mr. NIELSON. And how did that Commission do on that goal of 2 years?

Mr. PHILLIPS. I am not sure.

Mr. NIELSON. From 1975.

Mr. PHILLIPS. I think they fell short. But the Commission today is falling short. But this is a goal that is a proper one.

Mr. NIELSON. The Commission today is doing it. According to your numbers they only did 9 percent, so that is every 10.7 years.

Mr. PHILLIPS. That is over investment advisors, not investment companies. And that is an inadequate cycle.

Mr. NIELSON. But that was followed right immediately after 2 years and so on, 4 years. And then you said, it takes 10.7 years.

According to my simple arithmetic, if they are only doing it every 10 years now and the goal is 2 years, that would require an increase in staff by a multiple of five, would it not?

Mr. PHILLIPS. That is right according to that arithmetic.

Mr. **Nielson**. And that would require a budget several million dollars more than we can afford right now.

Mr. **Phillips**. I am not sure of the numbers, but the staff we are talking about——

Mr. **Nielson**. I am using your numbers.

Mr. **Phillips**. No; the staff—no; the entire Commission staff is not involved in inspections.

Mr. **Nielson**. Of that portion of the staff that is involved in inspection it would have to multiply by five.

Mr. **Phillips**. You would have to multiply it by five.

Mr. **Nielson**. Do you have any idea how much money that would involve?

Mr. **Phillips**. That is correct.

Mr. **Nielson**. Do you have any idea how much money that would require?

Mr. **Phillips**. No; I do not. It would involve several million, but it would be a small price.

Mr. **Nielson**. And if they did increase that area, would they be neglecting some other things such as the mergers you just admitted was——

Mr. **Phillips**. If they did it without increasing the budget, they would very definitely be neglecting other areas.

Mr. **Nielson**. OK, let me ask you another question. You have—been mentioned by Mr. Griffin and others that States can do it themselves and they have funds that they are self-funding in other States. Why do not the States and SRO's do more on their own?

Mr. **Phillips**. I think that the States and the SRO's are doing more. Perhaps, they can do even more. But there are jurisdictional limitations on their abilities. State jurisdictional authority ends at the State line. Many of the problems cross State lines. One cannot adequately investigate—many kinds of fraud with only statewide authority.

The SRO's have similar problems. They have no subpoena power. They can only get witnesses and records from their own members and their employees. Many of the frauds are far more widespread and cannot be investigated under this limitations.

Mr. **Nielson**. Let me give you an easy——

Mr. **Phillips**. There is no substitute for Federal authority here.

Mr. **Nielson**. My last question, let me give you an easy question. One we have to face all the time.

Since it is not likely to have increases in spending in this or any other agency, freezes or, at most, inflation increases are the order of the day. And since, as I believe, the increased fees are not necessary because you are already paying more and have a surplus in that area.

Assuming you had the same budget as last year, or an increase by inflation, how would you recommend SEC reevaluate or redistribute their funds? Would you put more into watching the mergers? Would you put more into reviewing these—inspecting these registered investments? How would you—what would you suggest, since I do not think increased funding is an option?

Mr. **Phillips**. I cannot quarrel with the priorities set by the present Commission. I think they have done a very intelligent, effective job of managing their limited resources.

I think the alternative under the conditions prescribed by you would be to ask the SEC to pressure the SRO's to do more, perhaps, as I suggested, set up a new SRO or use the NASD to conduct investment company and investment adviser inspections. Under the scenario that you have suggested, the only alternative is to rely more heavily on the SRO's, and perhaps, also, on the States.

Mr. NIELSON. May I ask the same question of Mr. Griffin? Same question, Mr. Griffin. If you have the same resources as today, assuming that is the only option. I am not saying it is, but with the budget constraints it appears to be the only option we are looking at right now.

How would you suggest SEC use their staff resources? What different things would you do?

Mr. GRIFFIN. I think I would shift substantial resources away from deregulatory efforts that proceed in corporation finance to enforcement, investment management, and market regulation.

Mr. NIELSON. Thank you, Mr. Chairman.

Mr. WIRTH. Thank you very much, Mr. Nielson. Mr. Oxley.

Mr. OXLEY. Thank you, Mr. Chairman.

Mr. Phillips, you mentioned in your testimony that without an effective SEC there would be no investor confidence. Is that a fair statement?

Mr. PHILLIPS. I believe it is.

Mr. OXLEY. And then later in response to a question, I thought I heard you say that investor confidence really results from a healthy economy. Can you make a distinction between your earlier statement and your answer to the question?

Mr. PHILLIPS. No; I think that I said the increased investor activity that we have seen in recent months may result from confidence in the economy. I do not believe, however, that that confidence can be maintained without full disclosure and prevention of fraud. That is the SEC's job, and it is necessary to maintain the confidence.

Mr. OXLEY. Well, let me ask you this then. You had a discussion on some statistics with my friend from Utah, who is an expert in those areas, and I would never tread in his territory on statistics.

Mr. PHILLIPS. I made the mistake of trying.

Mr. OXLEY. For example, the SEC in 1981 had 748 investment company adviser inspections. In 1985 it was over 1,600, which is a 115-percent increase. Corporate filings reviewed in 1981 were over 6,000; in 1985 over 9,000, for a 54-percent increase. Enforcement actions were up 41 percent.

Do you quarrel with those figures?

Mr. PHILLIPS. No. The SEC has done an impressive job with their resources. What I am saying, more importantly, while you can quibble with the statistics, that misses the point. What I am saying is, a 41-percent increase cannot cope with a 700-percent increase in trading volume, or a 500-percent increase in salesmen.

Moreover, if you look over 10 years, the record shows not a 41-percent increase, but a decline in enforcement activity.

The SEC is using a base year of 1980 on their numbers and I have used a base year of 1975, which was not atypical during that period, when volume was much lower. In fact, despite enormous increases in volume, there has been a decline from 1975.

Mr. **Oxley**. But your testimony is that within the existing strictures, the SEC is doing a good job. You just want them to have more money and more staff, basically.

Mr. Griffin, you commented about the diminishing role I believe, in response to a question, of individual investors. Do you have evidence to indicate that the individual investor is getting out of the market?

Mr. **Griffin**. I think there have been published reports over the last several months, or actually during the entire period of time that the market has been going up, that the percentage of trading in the various issues on the stock exchanges dominated by institutions, that is pension funds, mutual funds, and things like that, are increasing. And the percentage activity by individual investors are decreasing.

Mr. **Oxley**. Well, is it not a fact, though, that in real numbers, there are more individuals involved in the market today than there have ever been before?

Mr. **Griffin**. I do not know the answer to that question.

Mr. **Oxley**. Do you know, Mr. Phillips?

Mr. **Phillips**. There may be more individuals in the market, but the markets are much larger, so that in terms of relative importance, individuals are much less important today than they were, say, 10 or 20 years ago.

Mr. **Oxley**. Well, there are a lot of reasons behind that. Let us explore that, if you will.

You talked about mutual funds?

Mr. **Griffin**. Yes.

Mr. **Oxley**. I read an article in—I think it was Money magazine—just last week indicating an explosion in the availability and attractiveness of mutual funds. Why do you think that is. Do you think that is a result of individuals losing confidence in the markets, or does it really provide another opportunity for the individual to participate in the markets, perhaps not as directly as he might have as an individual investor?

Mr. **Griffin**. I think a lot of the reason is that the mutual funds have performed rather well in the last few years. But my personal——

Mr. **Oxley**. Well, that is kind of a chicken and egg thing, is it not? I mean, obviously they have performed well because more people are getting involved in mutual funds. The article in Money magazine indicated that just a few years ago mutual funds were almost totally ignored by individuals.

Mr. **Griffin**. I think they performed well because the market has gone up. I do not think it really reflects the number of investors who have been flocking to mutual funds. But more importantly, my personal view of that, Congressman, is that people are seeking some kind of safety, something to rely on, rather than their own acumen in this marketplace.

Mr. **Oxley**. What is wrong with that?

Mr. **Griffin**. I think what it reflects—I am not suggesting anything is wrong or right with it—is that they no longer believe—at least a large number of people no longer believe, that they have the ability to compete with the inside information that moves in the market. And, I think that is a reflection of a reduced ability of the SEC to enforce that kind of confidence that may have existed 10 or 15 years ago.

Mr. OXLEY. Well, I see individual participation through mutual funds as a very positive kind of thing. I am in mutual funds because I do not have time to sit there and go through the Wall Street Journal every day and determine how ABC's stock is doing.

And so, consequently, I put some confidence in those people who, for their living, do that. And I do not think that is bad. In some ways, in my estimation, it is akin to political action committees. I hate to bring it up—but political action committees are indeed really just individuals who are participating through the political action committee.

The same kind of thing goes in a mutual fund.

I just did not want to let your testimony go by without indicating that I felt you gave at least some indication of a negative feeling toward mutual funds and participation in them. I think it signals a very positive thing in the markets, and that this is one way that the individual can participate in the markets—particularly those people who do not have a whole lot of money to participate in equities normally.

Mr. LUKEN. Will the gentleman yield?

Mr. OXLEY. Let him answer the——

Mr. GRIFFIN. Very briefly, I do not disagree with that, but I do not want to put more emphasis on this than it deserves. I approve of investment in mutual funds wholeheartedly. I, too, invest in them for the reasons you suggested.

But I think another reason implicit in that is that people like us, who have other things to do, no longer think that we have adequate access to information to compete on an equal basis.

Mr. OXLEY. Do you think that occurred at some point?

Mr. GRIFFIN. I think it has been occurring over time.

Mr. OXLEY. But only with the big investors, not with the small investor who has $500 or $1,000.

Mr. GRIFFIN. I am suggesting that small investors do not feel able to compete with the institutions.

Mr. OXLEY. I am not sure they ever did.

Mr. GRIFFIN. I think if you look at the history of the stock market, probably they did, to a greater degree than they do today.

Mr. OXLEY. Well, I would challenge that. If you have some statistics on that, I would love to see them.

Mr. LUKEN. Will the gentleman yield.

Mr. OXLEY. Yes; of course.

Mr. LUKEN. I think the gentleman brings up a good point when he illustrates the fact that he, himself, relies upon those who make their living at it in purchasing mutual funds. And we had an example here, not long ago, where the city of Pompano and the city of Toledo came in with reference to their transactions with the Government securities dealers who were unregulated. Nobody was watching them, at all. And they said we are depending upon the regulators.

And I think the gentleman has brought up a very good point. If the gentleman does not have time to look at it himself, and is dependent on people who are in the business, then somebody ought to be watching those people, and there ought to be adequate regulations. They ought to be looking at the 10-K's. They ought to be—I think that is more reason for a special kind of a watchful eye, a special kind of diligence, which is obviously not being practiced here. It was admitted it is not being practiced, because they do not have sufficient staff.

I yield back to the gentleman.

Mr. **Oxley**. Well, of course, we did pass legislation dealing with that specific problem that developed in our home State. And I am sure that we are both hopeful that the Senate will act expeditiously on that legislation.

Mr. **Luken**. Well, I am suggesting the gentleman is not being necessarily consistent to say that we observe that because of these concrete instances that we found, we should regulate Government securities dealers and at the same time, in effect, deregulate much of what the SEC is supposed to be regulating by reason of the fact that they do not have the staff to enforce it.

Mr. **Oxley**. Well, if the gentleman had listened to some of the statistics that I read to Mr. Phillips, I would think that is far from deregulation. As a matter of fact, I would consider a 115-percent increase in investment of company advisers inspections or a 41-percent increase in enforcement actions a positive, not a negative.

But to go on, Mr. Griffin, on page 9 of your prepared testimony you argue that the Commission should examine the qualitative aspect of public offerings. Would not this create a need for substantial additional staff resources, and if so, where does the increased funding come from?

Mr. **Griffin**. Well, I would suggest that you look at the States as a crucible for seeing how these things worked in the past. If you have better front-end regulation, you can reduce your enforcement efforts, because you do not have the kinds of problems created later, if you are able to weed out some of the bad companies.

Certainly, the States that have adequate kinds of review procedures are able to operate more efficiently, simply because it is much less expensive to regulate on the front end than try to go to court to enforce on the back end.

Mr. **Oxley**. Assuming full disclosure, why should—this is somewhat of a philosophical question—why should the Government decide what venture the investing public ought to or ought not to have an opportunity to invest in?

Mr. **Griffin**. Because all of the players do not come to the table with an equal quantity of knowledge and understanding of the markets. I am not suggesting that we should interfere with sophisticated investors—institutional investors, pension funds; institutions of that sort can take care of themselves.

Many individuals, particularly on the low end of the securities markets are sold securities. They do not buy them. They receive a prospectus when they get their confirmation, not when the transaction takes place over the phone.

These people need some protection. We give protection throughout the spectrum of American life. We have consumer protection laws in all areas and I think investments are an area that this needs to be considered in.

Mr. **Oxley**. Thank you.

Thank you, Mr. Chairman.

Mr. **Wirth**. Mr. Moorhead.

Mr. **Moorhead**. Thank you.

On page 9 of your testimony, Mr. Griffin, you allude to the fact that the SEC is not reviewing initial registration statements filed by banks in connection with holding company reorganizations, because these are already filed with appropriate bank agencies.

What specifically is the basis for that statement, that these bank agencies are not adequate to protect the public?

Mr. **Phillips**. I think that was my statement, Mr. Moorhead.

Mr. **Moorhead**. Thank you, Mr. Phillips.

Mr. **Phillips**. There are significant differences in the application of disclosure standards between the SEC and some of the banking agencies, as well as the regulators of thrift institutions. These differences require substantial changes to disclosures when an institution has to shift its filings from its thrift or banking regulatory agency to the SEC. There are substantial changes in the application of accounting principles and other disclosures.

For that reason, I think it is important that the SEC look at these first time filings in order to see whether they comply with its disclosure requirements.

Mr. **Moorhead**. There is one thing—of course, obviously between the various agencies, as far as financial institutions are concerned, the whole review has been vulcanized depending upon what kind of a financial institution it is. It goes to a different board, and they all have different sets of rules.

I think that is a very complicating situation.

Mr. **Phillips**. Yes; it is.

Mr. **Moorhead**. But there is one situation that I have come across that I think is outrageous. If a savings and loan has been a stock company for less than 3 years and an adverse takeover is threatened, their company nor their board of directors can buy shares of stock while the people desiring to take over can put up an offer and buy as many shares as they desire.

Is there any move to protect the public against that kind of a situation?

Mr. **Phillips**. That is a problem that arises from the conversion rules of the Federal Home Loan Bank Board. I know there has been considerable discussion of that issue. Hopefully, the Board will be impelled to make some adjustments in those rules.

But it is a problem. I agree with you. It is a clear problem.

Mr. **Moorhead**. The other problem that comes up in connection with these adverse takeovers is that institutional owners of shares own such a large percent of the stock in many companies, that it is very easy to go to them and affect the transactions that are necessary to take over a well-controlled, well-run business that may be very important to a community.

And it would seem to me that the regulating agencies owe a greater degree of responsibility when those situations are happening, where the transactions are coldblooded, rather than something that is desired for the benefit of the community or the benefit of the institutions themselves.

I wondered whether there is anything that you could recommend about that?

Mr. PHILLIPS. Part of the problem in the situation you referred to is the absence of any clear definition of what constitutes a tender offer and is subject to tender offer regulation. There is a need to reexamine that issue and to see if a definition that might cover that situation and draw the proper lines can be worked out.

It is a project that I would hope that the SEC will undertake and can come up with some results. It is a question that you might inquire into when the SEC testifies. It is very important.

Mr. MOORHEAD. Thank you very much.

Mr. WIRTH. Mr. Fields.

Mr. FIELDS. Thank you, Mr. Chairman.

I have one question of Mr. Phillips. If I understood the thrust of your testimony, you basically said that the SEC is doing a good job, they just need more money. Let us assume the unusual, that Congress stays with Gramm-Rudman and there is no additional budget authority. How would you prioritize the Commission's responsibilities and their resource commitments?

Mr. PHILLIPS. I think, more or less the way they have themselves. Emphasis, should be placed insofar as possible, on inspections of investment companies, investment advisers and broker-dealers and on increased efforts to obtain more resources for such inspections from the self-regulatory agencies.

There should to be serious consideration of either asking the NASD or forming a new self-regulatory organization to conduct inspections of investment advisers and investment companies. That is area where I think the SRO's can be used more effectively and should be.

Mr. FIELDS. Thank you, Mr. Chairman.

Mr. WIRTH. Gentlemen, we thank you very much for your participation.

Mr. LUKEN. Mr. Chairman, can I ask one more question of Mr. Phillips?

We have your testimony, Mr. Phillips, that has been alluded to on page 2, with reference to the trend in actions and enforcement by the SEC since 1975. And what they appear to show is that there has not been an increase. As a matter of fact, there has been a tailing off in spite of the fact that there is a tripling of investor complaints.

Now the SEC, in their annual report—is that what this is—the 51st annual report—used the period from 1981-85 and they come up with different kinds of comparisons.

Do you have any comment, before you get off the stand here, as to why it would be so dramatically different between 1975 and 1985 and 1981 and 1985?

Mr. PHILLIPS. My analysis is also based on the SEC statistics. First, 1980-81 was a low point of SEC enforcement activity as there was a change of administration, and even before the change of administration, a dramatic shift in the focus of enforcement activity.

Second, the SEC is bringing more reporting cases, 16(a) reporting cases, which are much simpler. They are bringing more insider trading cases, which can be complex, but on the whole are more simpler than an overseas payment case or a complex financial fraud.

They are also adopting, in my view for very good reasons, the practice of conducting an investigation, gathering the evidence against one group of defendants, bringing an action and then continuing the investigation to see whether there is cause for prosecution of another group. Thus, one investigation may give rise to several enforcement actions, and the resources of the SEC are used up in the investigatory stage, not in the prosecuting stage.

In addition, they have very effective leadership; they are a very capable staff, and they indeed may be more productive.

Mr. LUKEN. But I was getting at—and you have answered it, but I just want you to answer as completely as you can. Why the differences between the two periods, the last 1970's and the early 1980's?

Mr. PHILLIPS. Oh, the differences are very simple. There has been a decline from 1975 to 1985 because they do not have the people. There is no way to conduct investigations and bring enforcement actions without manpower.

Mr. LUKEN. Well, I would just like to conclude by observing that Mr. Phillips, you got a lot of questions from the other side of the aisle and the other witnesses, as to why you were using hearsay and why you did not always have hard evidence. And I suggest that if those would be the criteria, these hearings would be very short, as would be the questioning from the other side of the aisle.

This is not a court of law, obviously.

Mr. OXLEY. Thank you, judge.

Mr. WIRTH. Thank you, Mr. Luken.

Mr. Griffin, Mr. Schultz, Mr. Phillips, we thank you for being here.

I might note, Mr. Phillips, that the concern about the disposition of more than 30,000 complaints coming into the SEC is a question left up in the air today and we will be in written request to the SEC, following up as to what happens to those complaints. I think that is a concern that both you and Mr. Griffin raised this morning.

Further, I might point out that the two of you, representing as you do NASAA and the American Bar Association's Committee on Federal Regulation—although you are speaking on your own behalf today, Mr. Phillips—are coming in to provide the committee with your perspective on what the SEC ought to be doing.

It is not your job to develop a budget; it is not your job to allocate budgets, nor to go to the White House to suggest that they appropriate funds or request the funds be appropriated.

What is your job, which I believe you are doing very constructively, is to say, from where you sit, from the perspective of the bar, from the perspective of the States, what decisions ought to be made, what allocations ought to be made, what kinds of dangers may we have if certain steps aren't taken. And I think that is a very constructive part of the dialog, and many of us share your perspective on what ought to be done, and obviously others do not. But I think that that kind of constructive discussion is very appropriate, and we very much appreciate your being here and helping us with your views.

Mr. Schultz, we look forward to your completed report, not only the one coming to the subcommittee, but the one going to the chairman of the full committee, Mr. Dingell, and if you would again pass on our appreciation to your colleagues at the GAO for your continued assistance, we appreciate it.

Mr. **Schultz**. Thank you, Mr. Chairman.

Mr. **Wirth**. Gentlemen, thank you all very much for being here.

Mr. **Phillips**. Thank you, Mr. Chairman.

Mr. **Wirth**. We will keep the record open for whatever further questions members of the committee may have. Thank you all very much for being here.

Mr. **Griffin**. Thank you.

Mr. **Wirth**. Chairman Shad, thank you very much for coming. We appreciate the attendance of you and your colleagues, and we also appreciate your patience in waiting through the lengthy questioning of the first panel.

Now, Mr. Chairman, I would note a fact that I'm sure you're aware of, that this is your 13th appearance before the subcommittee, and I can see the gratitude on your face to be thinking about the fact that we remember that and that you remember all 12 previous appearances.

More importantly, I would note that you are now completing your fifth year as Chairman of the Securities Exchange Commission, I believe having served longer than any Chairman in the Commission's 51-year history. I want to say that while we haven't agreed upon everything in your 5-year tenure, we appreciate your still coming back over and over to help the subcommittee, and on behalf of the subcommittee, I want to reflect our appreciation of your dedication and energy and commitment to the task that you face in a time of enormous change in our financial markets. As we have heard this morning, there has been increasing volume, changing kinds of instruments, a changing role for the SEC, and in fact a changing outlook in the Government.

Commissioner Cox and Commissioner Peters have been here before. We appreciate your coming back. And to Messrs. Fleishman and Grundfest, who are here for the first time, we appreciate your coming, and we know that you're going to be eager to get into double figures, along with Chairman Shad.

Mr. Chairman, thank you very much, and we look forward to hearing from you. As you know, your statement and whatever views you would like to add to that will be included in full in the record, and we would ask if you could, as ever, summarize your views, and we look forward to hearing from you.

Thank you for joining us.

STATEMENT OF JOHN S.R. SHAD, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, ACCOMPANIED BY CHARLES C. COX, COMMISSIONER; AULANA L. PETERS, COMMISSIONER; JOHN HUBER, DIRECTOR, DIVISION OF CORPORATE FINANCE; AND GARY LYNCH, DIRECTOR, DIVISION OF ENFORCEMENT

Mr. **Shad**. Thank you very much, Chairman Wirth. And I think I can speak on behalf of all the Commissioners in expressing our appreciation for these very constructive hearings.

The Securities and Exchange Commission appreciates the opportunity to respond to the questions raised in your letter of February 19 inviting the Commission to testify at this hearing.

Security markets are, of course, subject to significant rises and declines, but America does have today by far the best securities markets the world has ever known: the broadest, the most active, efficient, and the fairest.

Within the past 5 years, there have been some significant failures of unregulated Government securities dealers, but negligible failures of registered investment companies, transfer and clearing agencies, and very few registered broker-dealer failures.

The securities markets are not perfect, but, with the benefit of ongoing programs and staff efforts, tomorrow's markets will be even better than today's.

I might interject that there were many constructive suggestions during the first panel's discussions. I don't think there were any areas raised that the SEC is not sensitive to, and, in fact, the SEC is taking actions in anticipation of or in response to those questions, and taking the initiative in important areas of the securities markets that were not raised. I think we're much more sensitive and aware of the problems than others who are outside observers.

The programs and efforts that are underway at the present time include increasing the coordination of investor protection by the SEC with the SRO's, State securities commissions, and the Department of Justice; high-speed electronic filing, processing, dissemination, and analysis of time-sensitive corporate information; international surveillance and enforcement efforts; certificate immobilization; functional regulation; paperwork reduction and automation.

As to whether the Commission has adequate staff and other resources to carry out its mission and whether it is setting appropriate priorities, the Commission has submitted to this subcommittee a proposed amendment to its fiscal year 1986 authorization to include $5.8 million per annum for its internal EDGAR electronic disclosure system, which is principally for computer work stations and hardware and software. The $5.8 million is included in the President's proposed fiscal year 1987 budget, and the authorization amendment will not require an increase in any appropriations approved or pending before Congress.

The EDGAR system has been designed by the SEC staff, Arthur Andersen, IBM, and Dow Jones to increase the efficiency and fairness of the securities markets by accelerating dramatically the filing, processing, dissemination, and analysis of time-sensitive corporate information. The EDGAR pilot has demonstrated the feasibility and multiple benefits of the system.

The staff originally proposed that the EDGAR system be financed entirely through user fees, as in the case of the Commission's 18-year-old microfiche system. However, as a result of subsequent discussions with Members of Congress and public comments, it has been determined that the internal processing requirements should be financed with appropriated funds, and that the prime contractor should look to user fees to finance the external system for the receipt and dissemination of corporate filings.

The restructuring of the financing to include appropriated funds and the time required for additional public comment have necessitated the proposed authorization amendment, a request for delegation of procurement authority from GSA, and an extension of the pilot. A notice of the follow-on pilot contract is being published this week.

The staff plans to select the prime contractor in fiscal year 1987 and begin phasing in the 11,000 publicly owned companies and 2,700 investment companies over 3 years.

With reference to the Commission's budget, while many independent agencies' budgets have been reduced, contrary to a common misperception the SEC's budget has been increased by over 35 percent since 1981. In each of the last 3 fiscal years, registration, transfer, and other fees have exceeded the Commission's $90 to $106 million budget. The 3-year surplus has amounted to $73 million, and the 1986 and 1987 surpluses are expected to aggregate over $100 million.

The Commission's budget, personnel, and fees are set by Congress. The fees are remitted to the Treasury as received. Gramm-Rudman-Hollings will reduce the SEC's fiscal year 1986 $111.1 million appropriation and 1,974 staff-years by $4,800,000 and 60 staff-years, to $106,300,000 and 1,914 permanent staff-years.

The President's proposed fiscal year 1987 SEC budget is $110 million and 1,973 permanent staff-years, which will be an increase over the Gramm-Rudman-Hollings level, of course.

With reference to the Commission's ongoing operations, there were many different statistics mentioned during the morning panel. We have keyed ours off of 1981, when there was a change in terms of the direction of the Commission. And so we've made comparisons between 1981 and 1985 and in some cases the current year to date.

Since fiscal year 1981, through automation, paperwork reduction, and other staff initiatives, each SEC division has achieved record results or the highest levels in years, with 2 to 5 percent less personnel. Since fiscal year 1981, the annual volume of appellant and other cases has been increased by over 35 percent, enforcement actions by over 40 percent, corporate filings reviewed by over 50 percent, broker-dealer oversight examinations by over 60 percent, self-regulatory organization oversight inspections by over 70 percent, and investment company and adviser inspections by over 100 percent.

The Commission has also been increasing the coordination of its efforts with the SRO's, the State securities commissions, and the Justice Department. In a recent roundtable discussion with these groups, a variety of ideas and suggestions were ventilated, including developing better guidelines for the various areas of responsibility, and through task force and other efforts, increasing the effectiveness of our joint efforts, because we do have different levels of responsibility for the protection of investors.

And, at the SEC's initiative, all of the major stock exchanges and the NASD have implemented or are well along in implementing electronic surveillance systems and transaction audit trails, which facilitate the detection of market manipulators and inside traders and reduce transaction reconciliation costs that are normally borne by investors.

The staff systematically selects broker-dealers with the greatest customer exposure for the most frequent oversight examinations. These examinations are being enhanced by automatic systems designed to detect account churning and to track SRO disciplinary actions and SEC referrals to the SRO's. There was a question raised during the prior panel as to how we follow up. Well, this has been largely automated since 1982, and there is definite followup on these referrals.

The selective review of corporate filings, staff specialization, and access to external data bases enable the staff to concentrate its efforts in the areas where they are most effective. This is a major improvement over what was done 10 years ago, as referred to in the earlier panel.

Investment company and adviser inspections are being enhanced through systems examinations of investment company complexes and by targeting high-risk entities such as advisory firms that handle customers' funds or securities. The system of examination by complex is a major improvement in the ability of the Commission to inspect investment companies.

The staff is increasing the coordination of the investment adviser inspection program with State securities personnel to reduce duplicative efforts. In 1985, the staff assisted 16 States in the training of their personnel and conducted 125 joint inspections. The staff is reviewing proposals for the formation of SRO's to supervise investment advisers and financial planners.

In two concept releases, the Commission has suggested approaches and solicited comments on ways to facilitate the international mobility of capital and to coordinate and improve international disclosure, distribution, surveillance, and enforcement practices. Extensive comments have been received and approaches are being considered here and abroad.

Very favorable reactions have been received from investment, corporate, and financial executives to accelerating the immobilization of security certificates through greater use of central depositories and electronic book entry systems. This is particularly true of Ginnie Mae securities, which are not within the Commission's jurisdiction.

Corporate, municipal, agency, and other issuers of debt securities are being encouraged to do their future public offerings on a book entry basis. There have been over $2 billion of successful money market, debt, and preferred offerings and over $800 million of municipal bond offerings on book-entry bases. And most important, the U.S. Treasury has announced that starting this year, all future Treasury securities will be issued on an electronic book-entry basis.

Securities certificates will not be eliminated in the near future, but billion-dollar benefits will be realized and a lot of future problems—paperwork and other problems—avoided by gradually turning off the flow of new paper into the marketplace. This is a major area which was not brought up in the prior discussions, and I would emphasize that in the Ginnie Mae situation, where the closings get pretty dramatic because they lack a book entry or a central depository system, we are cooperating and assisting even though it is not an area of our direct jurisdiction. We are planning to have meetings with those responsible for that area.

The staff is preparing a concept release on tender offers to solicit comments on whether to regulate "poison pills," acquisitions of substantial shareholdings once a conventional tender offer has commenced, and whether to permit corporate self-governance through shareholder-approved charter amendments of certain regulations under the Williams Act.

During the coming year, the enforcement program is expected to emphasize fraud and disclosure violations by reporting companies, violations by regulated entities and associated persons, offering violations, insider trading, and market manipulation cases.

Chairman Wirth also raised the question as to whether the Commission has sufficient statutory authority to protect investors and maintain the integrity of the capital markets. The SEC has very broad authority under the multiple securities laws and regulations which it administers. The Commission will submit to this subcommittee shortly proposed legislation to reduce from 10 to 2 calendar days the filing of initial 13(d) disclosures of acquisitions of over 5 percent interest in companies.

The Commission has supported legislation that would require the banks to conduct certain of their securities activities through affiliates that are subject to the same rules and regulations as all other securities firms.

The Commission has also supported repeal of the Public Utility Holding Company Act, which is recommended in the President's 1986 and 1987 budgets. The Commission achieved the objectives of the Public Utility Holding Company Act over 20 years ago. Repeal would result in significant savings.

And now if you wish me to do so, I would be pleased to provide some brief facts on some of the issues raised during this morning's panel.

[Testimony resumes on p. 251.]

[The prepared statement of Mr. Shad follows:]

STATEMENT OF JOHN SHAD,
CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION,
BEFORE THE SUBCOMMITTEE ON TELECOMMUNICATIONS,
CONSUMER PROTECTION, AND FINANCE OF THE HOUSE
COMMITTEE ON ENERGY AND COMMERCE

OVERSIGHT HEARING

March 5, 1986

Chairman Wirth and Members of the Subcommittee:

The Securities and Exchange Commission appreciates this opportunity to present an overview of its fiscal 1985 activities and ongoing efforts. 1/

America has today by far the best securities markets the world has ever known -- the broadest, the most active and efficient, and the fairest. They are not perfect, but with the benefit of ongoing efforts to implement electronic disclosure, international surveillance and enforcement, certificate immobilization, functional regulation, paperwork reduction and automation programs, tomorrow's markets will be even better than today's.

Fiscal 1985 highlights include:

Results: Record results were achieved in the number of investment company, adviser and self-regulatory organization inspections, corporate filings reviewed and broker-dealer oversight examinations.

1/ The views in this statement do not necessarily reflect the views of the Administration. See Section 111 of Pub. L. No. 93-495, 88 Stat. 1500 (Oct. 28, 1974) (codified at 12 U.S.C. 250).

Since fiscal 1981, through automation, paperwork reduction and other improvements and staff initiatives, each SEC division has achieved record results, or the highest levels in years, with 2% to 5% less personnel. The annual volume of:

Appellate and other cases has been increased by over 35%;
Enforcement actions by over 40%;
Corporate filings reviewed by over 50%;
Broker-dealer oversight examinations by over 60%;
Self-regulatory organization inspections by over 70%; and
Investment company and adviser inspections by over 100%.

Fiscal Years Ended Sept. 30	1981	1982	1983	1984	1985	1981-85 Change
Investment Co. and Adviser Inspections	748	1,065	1,085	1,334	1,606*	+115%
SRO† Inspection	12	19	18	20	21*	+75%
Broker Oversight Examinations	278	249	324	389	447*	+61%
Corporate Filings Reviewed	6,087	6,197	6,849	7,114	9,382*	+54%
Enforcement Actions	191	254	261	299*	269	+41%
Appellate and Other Cases	102	115	143	167*	141	+38%
Staff Years	1,982	1,881	1,921	1,885	1,936	2%
Fees as Percent of Budget	81%	94%	110%	129%	135%	

* A record or the highest level in years

† Self Regulatory Organization

SEC Budget: While many independent agencies' budgets have been reduced, contrary to a common misconception, the SEC's budget has been increased by over 35% since 1981.

Moreover, in each of the last three fiscal years, registration, transfer and other fees have exceeded the Commission's $90 to $106 million budget, which has only happened once before in the

Commission's 51-year history. The 1983-85 surplus amounted to over $70 million and the 1986 and 1987 surpluses are expected to exceed $45 and $55 million, respectively. The Commission's budget, personnel and fees are set by Congress. The fees are remitted to the Treasury as received.

Enforcement: The 269 enforcement actions brought during fiscal 1985 was 30 less than in 1984, due to an increase in resource intensive financial reporting cases and a 31 case reduction in delinquent filing cases against single individuals. In fiscal 1985, 54 actions (20% of the total) were financial disclosure cases. Some were products of the 1982 recession and the 1983 "hot issues" markets. It is during such periods that some companies and executives are most prone to "cook the books". Actions against brokers and other regulated entities amounted to 42% of the cases and insider trading 7%. The remaining 31% involved market manipulation, internal accounting control deficiency, Foreign Corrupt Practices Act, delinquent filing by reporting companies, and other areas.

The Commission has begun seeking fines under the Insider Trading Sanctions Act ("ITSA"), which was proposed by the Commission, sponsored by Congressmen Dingell, Wirth, Broyhill, Rinaldo and other Subcommittee Members and Senators Garn, D'Amato, Proxmire, Sarbanes and other Senate Banking Committee Members, and signed into law in August, 1984. The ITSA permits the Commission to seek court imposed fines up to three times insider trading profits (or losses avoided).

Last week, the Commission announced a record insider trading disgorgement: the recovery of more than $7.8 million from a group of Middle Eastern inside traders who attempted to shield themselves behind Swiss bank secrecy laws. The aggressive and successful pursuit of this matter is a signal of the Commission's improved abilities to locate and prosecute inside traders wherever they may be.

Government Securities: Government securities dealer failures during the past year resulted in seven enforcement actions. At the request of this Subcommittee, in consultation with the Federal Reserve Board and the Department of the Treasury, the Commission prepared and delivered to Congress in June, a study of the government securities market and proposed a legislative approach, if deemed necessary by Congress. 1/

Shareholder Communications: To facilitate shareholder communications, the Commission approved rules in August, 1984, which require brokers to begin providing corporations on January 1, 1986, with the identity of their shareholders who do not object. 2/ The Commission also proposed, and Congressmen Wirth and Rinaldo and Senator D'Amato sponsored, the Shareholder Communications Act, which was signed into law on December 28, 1985. 3/ It

---

1/ Regulation of the Government Securities Market (June 20, 1985).

2/ Release No. 34-21339, 49 Fed. Reg. 38096 (Sept. 21, 1984).

3/ Pub. L. No. 99-222, 99th Cong., 1st Sess. (1985).

grants the Commission authority to require banks and savings and loan associations to begin providing corporations similar information on December 28, 1986.

Integrated Disclosure Program: The integration of corporations' registration and reporting requirements and the shelf registration rule are saving corporations for the benefit of their shareholders over a billion dollars per annum of interest, underwriting and paperwork costs -- without compromising full disclosures to the investing public. In fiscal 1985, the Commission adopted cost-saving forms that cover the registration of securities issued in business combinations and exchange offers. 1/

Marketplace Efficiency: Efforts to increase the breadth and efficiency of the securities markets include recent Commission decisions: to approve requests by the National Association of Securities Dealers ("NASD") to increase the number of National Market System over-the-counter ("OTC") stocks subject to firm quotes and last sale reports by 85% to 2,500 stocks; to require disclosure of dealer mark-ups; to permit each stock exchange to grant unlisted trading privileges in up to 25 OTC stocks; to test competitive side-by-side marketmaking by OTC dealers and the exchanges in six OTC stocks and options, through a one-year pilot; and to permit the New York Stock Exchange to make markets in certain options. Effective market surveillance is an integral part of these programs.

1/ Release No. 33-6578, 50 Fed. Reg. 18990 (May 6, 1985).

Audit Trails: At the Commission's initiative, fully functional transaction audit trails have been implemented by the American and New York stock exchanges. The Chicago Board Options Exchange and the NASD are also making substantial progress toward such systems. These systems increase investor protections and reduce transaction reconciliation costs that are ultimately borne by investors.

Bank Securities Activities: In 1985, the Commission adopted a rule 1/ which requires banks to conduct certain securities activities through broker-dealers registered under the Exchange Act. The validity of the rule has been upheld in litigation, which is on appeal. 2/

Options and Futures: New options and futures are permitting investors, banks, corporations and others, to hedge stock market, foreign currency and other risks at a fraction of the prior costs of hedging or reducing such risks, and in multibillion dollar amounts that were not previously possible. They have also increased the breadth and liquidity of the stock and other markets.

In December 1984, the Federal Reserve Board, the Commodity Futures Trading Commission and the SEC submitted to this Subcommittee a joint study 3/ which concluded that options and futures serve

---

1/ Release No. 34-22205, 50 Fed. Reg. 28385 (July 12, 1985).

2/ American Bankers Association v. SEC, No. 85-2482 (Oct. 30, 1985), appeal pending, No. 85-02492 (D.C. Cir. filed Oct. 30, 1985).

3/ Special Study of the Futures and Options Markets (Dec. 1984).

useful hedging and arbitrage purposes and do not adversely impact capital formation.

Congressional Hearings: The staff and Commissioners testified at 23 hearings on government securities, accounting, tender offers, internationalization of the securities markets, the Racketeer Influenced and Corrupt Organizations ("RICO") provisions of the criminal code and other matters upon which legislation is pending.

Ongoing Efforts

Major ongoing programs concern: increasing coordination of the SEC's efforts with those of the self-regulatory organizations ("SROs"), the state securities commissions and the Justice Department; the increasing internationalization of the securities markets; the immobilization of securities certificates; the SEC's electronic disclosure system; functional regulation of financial institutions; and corporate takeovers.

Coordination: The Commission is increasing the coordination of its efforts with those of the SROs, the state securities commissions and the Justice Department. In order to eliminate duplicative paperwork and increase the effectiveness of regulations, the Commission worked with the North American Securities Administrators Association ("NASAA") to develop new broker-dealer and investment adviser "plain English" registration forms, which are now in use. 1/

1/ Release No. 34-22468, 50 Fed. Reg. 41867 (Oct. 16, 1985); Release No. IA-967, 50 Fed. Reg. 18500 (May 1, 1985).

On February 26, 1986, the Commission conducted a Roundtable discussion on coordination of surveillance and enforcement efforts with representatives of the state securities administrators, the SROs and the Department of Justice. The Divisions of Enforcement, Investment Management and Market Regulation are increasing their referrals and follow-up efforts with these investor protection authorities. In addition, it has been suggested that the Commission set up a task force with the NASAA, to maximize state and federal securities law enforcement efforts.

Internationalization: For over two centuries, the United States has been a prime beneficiary of foreign investments. Last year U.S. corporations raised a record $45 billion in the Eurobond market, as compared with only $5.7 billion raised in our markets by foreign companies.

Approximately 10% of the transactions on the New York Stock Exchange are now originated abroad. The SEC recently approved linkages of the Boston and Montreal and the American and Toronto stock exchanges. U.S. firms have recently joined the Tokyo stock exchange and are acquiring substantial interests in London securities firms. The NASD and the London Stock Exchange plan to disseminate quotes on over 500 securities. Reuters plans to make Instinet's execution facilities available in Europe. And other major exchanges and market systems are considering linkages.

Today, over 325 companies' shares are actively trading in more than one country. It seems inevitable that within a year or two a multiple of that will be trading around the clock and the world, through networks that interconnect the major markets.

The increasing international mobility of capital offers enormous potential benefits to investors and the global economy, but there are problems. To cite a few, U.S. shareholders of foreign corporations are often at a disadvantage when such companies do rights or exchange offerings. The offering materials cannot be sent to U.S. shareholders, unless the securities are registered here and comply with our regulations. Statutory mergers of foreign companies have been complicated by regulatory problems posed in the solicitation of acceptances from their U.S. shareholders.

There are also obstacles to the effective surveillance and enforcement of fair and orderly international markets. It is in the interest of all nations to expose and prosecute those who would use foreign secrecy and blocking laws to shield manipulative and other illegal activities in our and other markets.

Some U.S. court decisions have been helpful. 1/ It has been held that those who play in our markets must do so by our rules and regulations. In some cases, the SEC has been able to freeze the

---

1/ See, e.g., SEC v. Banca della Svizzera Italiana, 92 F.R.D. 111 (S.D.N.Y. 1981); IIT v. Cornfeld, 619 F.2d 909 (2d Cir. 1980); SEC v. Kasser, 548 F.2d 109 (3d Cir.), cert. denied, 431 U.S. 938 (1977).

proceeds of illicit transactions from abroad. [1] Also, the SEC/Swiss Accord [2] on insider trading is a helpful international precedent, but it is only a beginning.

With a view to addressing these and other problems, the SEC has issued two concept releases, [3] which suggested approaches and solicited comments on ways to facilitate the international mobility of capital and to coordinate and improve international disclosure, distribution, surveillance and enforcement practices. Extensive comments have been received and approaches are being discussed with Canadian, United Kingdom and Japanese authorities.

Efforts are also underway to accelerate the clearance and settlement of international transactions. And mutually acceptable international surveillance and enforcement practices are being explored here and abroad.

At the request of the House Energy and Commerce Committee, the Commission is also conducting a study of the implications of the accelerating internationalization of the securities markets.

1/ SEC v. Certain Unknown Purchasers (the Santa Fe case), 81 Civ. 6553 (W.C.C.) (S.D.N.Y. 1981); SEC v. Banca della Svizzera Italiana, 81 Civ. 1836 (M.P.) (S.D.N.Y. 1981).

2/ Memorandum of Understanding Between the Government of Switzerland and the United States Securities and Exchange Commission (Aug. 31, 1982).

3/ Release No. 34-21958, 50 Fed. Reg. 16302 (Apr. 18, 1985); Release No. 33-6568, 50 Fed. Reg. 9281 (Mar. 7, 1985).

Immobilization of Securities Certificates: As recommended by Congress in 1975, 1/ the SEC is also attempting to accelerate the immobilization of securities certificates, through greater use of central depositories and proven electronic book-entry systems.

Over a trillion dollars of bank accounts and hundreds of billions of dollars of money market fund shares have been on book-entry systems for years. Over half of the securities listed on the New York Stock Exchange are now immobilized in depositories. However, the manual handling of the balance, as well as the mounting volume of new offerings, municipal and agency bonds and new financial instruments, costs corporations, the financial community and investors (who ultimately bear such costs) hundreds of millions of dollars per annum. And even in the absence of such potential savings, the paperwork and other problems avoided more than justify simplifying the process.

Tons of certificates are engraved and delivered daily, often by armed guards, to investors throughout the world. They are manually counted and recounted, and held in vaults and safety-deposit boxes. Multi-millions of dollars of certificates are lost, stolen, mutilated and counterfeited annually. Most of these expenses can be eliminated.

1/ Section 17A(a)(2) of the Securities Exchange Act of 1934, 15 U.S.C. 78q-1(a)(2), as amended by Pub. L. No. 94-29 (June 4, 1975).

At SEC forums conducted by the Division of Market Regulation, very favorable reactions have been received from broad cross-sections of investment, corporate and financial executives to the following voluntary approach.

The approach is to encourage corporations, municipalities and other issuers to do their future public offerings of debt securities in the form of single "Global Certificates" -- against which investors' interests are recorded by depositories on a book-entry basis. The savings over the life of a 20-year $100 million bond issue are estimated at $200,000.

Certain states are also being encouraged to update statutes that limit the use of central depositories by insurance companies 1/ or municipal pension funds 2/ or that have not as yet adopted the 1977 Uniform Commercial Code amendments that facilitate uncertificated securities interests. 3/ Such outdated state statutes do not prevent the use of global certificate book-entry systems, but they do impose unnecessary costs and burdens on investors and the financial community.

A group of issuers and transfer agents is also working on book-entry systems that would enable investors to be registered directly with issuers.

1/ Ark., Calif., La., N.M., S.D., Ut., W.Va. and Wy.

2/ N.J., Ohio, Ok., Tex. and Wy.

3/ The states that have adopted the 1977 UCC amendments are: Calif., Col., Conn., Del., Mass., Minn., Mont., N.Y., Ohio, Ok., Tex., Va., W.Va. and Wy.

There are many favorable developments. There have been over 30 successful public offerings of over $2 billion of book-entry money-market preferred and bond issues. Twelve states and over 20 municipalities have done public offerings of over $800 million of book-entry bond issues. IBM Credit has registered a billion dollars of debt, all or a portion of which may be sold in book-entry form.

France has commenced the conversion of all existing and new securities to an electronic book-entry system within three years.

And most important -- the U.S. Treasury has announced that this year it will stop issuing note and bond certificates. All future Treasury securities will be issued on an electronic book-entry basis.

Securities certificates will not be eliminated in the near future, but billion dollar benefits will be realized by gradually turning off the flow of new paper into the system.

Edgar: Subject to government approvals, the Commission plans to commence in fiscal 1987 implementation of the operational electronic disclosure system, known as Edgar. The 18-month pilot has demonstrated the feasibility and benefits of the system.

When fully implemented, the system will increase the efficiency and fairness of the securities markets by accelerating dramatically the filing, processing, dissemination and analysis of corporate information. As reports are filed electronically and accepted by the SEC, they will be instantly accessible to investors, securities analysts, the news media and others on home and business computer screens. Full disclosures by corporations will be publicly available in minutes instead of days or weeks.

Participants in the pilot include AT&T, General Motors, IBM, Exxon and other large and small companies, as well as the California, Georgia and Wisconsin state securities commissions. The pilot is being steadily upgraded and expanded. Over 340 participants, including over 180 investment companies and unit investment trusts that recently joined the system, have filed electronically over 4,000 documents.

Subject to Congressional approvals, the Commission plans to select the prime contractor for the operational system and to phase-in the 11,000 publicly-owned companies and 2,700 investment companies over three years.

Authorization Amendment: The Commission has submitted to this Subcommittee a proposal to amend its 1986-88 Authorization to include $5.8 million per annum in non-personnel costs for its internal Edgar processing requirements. The $5.8 million is included in the President's proposed budget for fiscal 1987, and the amendment will not require an increase in any appropriations approved or pending before Congress.

The Commission initially proposed that the Edgar system be financed entirely through user fees, as in the case of its present microfiche system. However, as a result of subsequent discussions with members of Congress and others, it has been determined that the Commission should pay for its internal processing requirements (e.g., computer work stations, hardware and software) out of appropriated funds at the rate of $5.8 million per annum for seven years (i.e., $40.6 million) and that the prime contractor should look to user fees to finance the external system for the receipt and dissemination of corporate filings.

Functional Regulation: The Commission supports the following unanimous recommendations of the Vice President's Task Group on Regulation of Financial Services:

- All banks and thrifts publicly issuing securities to the investing public should be subject to the registration requirements of the Securities Act of 1933; and
- Administration and enforcement of financial reporting and disclosure requirements under the Securities Exchange Act of 1934 should be transferred to the Commission. 1/

Corporate Takeovers: Some contend that rising institutional ownership and the threat of takeovers are forcing corporate managements to forego long-term growth programs for short-term earnings results. Others contend that takeovers bring the discipline of the marketplace to bear on corporate managements and accelerate the reallocation of assets, in response to changing economic conditions. There are many other reasonable contentions and concerns, but most lack empirical support.

1/ Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services at 91 (July 1984).

A recent study by the SEC Office of the Chief Economist of tender offers from 1981 through June of 1985, quantifies the benefits to common stockholders. They have received an average premium of 47% over the prior market price of their shares, and the bidders' shares have risen an average of 4% net-of-the-market. 1/ The 47% average premium amounts to about $39 billion.

From the point of view of investors, reliance on the marketplace, the Commission's full disclosure and other requirements under the Williams Act, and shareholders' voting and other rights under state and federal laws has generally worked well. 2/ From managements' point of view, a company's best defense to a takeover is of course a fairly valued stock. Corporate managements are in much better positions than outsiders to utilize their companies' enhanced borrowing capacities and asset values on a sound basis, for the benefit of their shareholders -- and the vast majority are doing so.

At the Commission's January 9, 1986 meeting on tender offer issues, it took the following actions:

1) The Commission approved a revised legislative proposal that would reduce the current ten calendar day period to two calendar days for the filing of initial beneficial ownership reports (13Ds). The "standstill" provision of the Commission's previous 13(d) legislative proposal was deleted.

1/ SEC Office of the Chief Economist, Any-or-all, Partial and Two-tier Tender Offers, (1985).

2/ *See also* Attachment A for a summary of the cases in which the Commission has expressed its views as *amicus curiae* on various issues relating to changes in corporate control.

2) The Commission adopted amendments to conform certain time period requirements governing issuer tender offers to those governing third-party tender offers. Under these amendments, identical time periods for minimum offering periods (twenty business days), withdrawal rights (an initial period of fifteen business days and ten business days after commencement of a competing bid), and proration rights (throughout the period the offer remains open) will apply to issuer and third-party tender offers.

3) The Commission approved publication of a release proposing that the previously proposed "best-price" rule be revised to provide:

   - that all holders must be paid the highest consideration paid (as opposed to offered) to any security holder.

   - that upon announcement of a decrease in the consideration offered or securities sought, withdrawal rights must be extended throughout the offer (but not reopened upon commencement of a competing bid), or in an alternative proposal, for an additional ten business days;

   - that a tender offer must remain open for at least ten business days upon announcement of an increase or decrease in the percentage of securities sought.

4) Final action on the "all holders" proposals for third-party and issuer tender offers was deferred until the Commission considers adoption of the revised "best price" rule.

5) The Commission instructed the staff to prepare for publication a concept release seeking public comment on possible approaches to certain takeover related activities. Specifically, the concept release will address the following topics:

   - whether after commencement of a conventional tender offer, substantial acquisitions of a target company's securities by any person, including the issuer and any previous bidder, should also proceed by a tender offer subject to the Williams Act.

   - recent developments in the evolution of "poison pills" and whether legislation or regulation in response to those developments is appropriate.

   - the possible reliance on corporate self-governance mechanisms as a means of introducing greater flexibility into takeover regulation. In particular, the release will explore the merits and drawbacks of a) permitting an exclusion from the pending all-holders rule for corporations whose stockholders vote to amend their charters so as to provide for such an exclusion, and

b) permitting corporations to modify other provisions of takeover regulations in accordance with shareholder-approved resolutions.

6) The Commission instructed the staff to meet with each Commissioner and determine whether there is a sufficient consensus on a definition of the term "tender offer" to warrant another attempt to codify the term.

7) The Commission also considered a variety of offensive and defensive takeover tactics and issues. The Commission determined not to take or recommend actions that would:

a) require that, after a person acquires a specified percentage of an issuer's securities, subsequent acquisitions may only be effected by means of a tender offer, whether for any or all of the shares;

b) require that, before commencing a tender offer, a bidder must obtain approval of its own shareholders;

c) require that, before commencing a tender offer, the bidder must submit its offer to the target's board, and that if a majority of the independent directors do not approve the offer, it must be submitted to the target's shareholders, and that pending their decision, the target company would be prohibited from taking any defensive actions;

d) require that, in partial tender offers, target shareholders be provided the opportunity to vote for or against the tender offer at the same time that they tender their shares;

e) prohibit or limit "two-tier" or partial tender offers;

f) prohibit or further regulate antitakeover charter and by-law amendments;

g) prohibit the granting of "golden parachutes";

h) prohibit "lock-ups" by target companies;

i) prohibit "greenmail" transactions;

j) require that bidders have "firm" financing commitments prior to commencing tender offers;

k) prohibit or limit the use of below investment grade securities ("junk bonds") to finance tender offers; and

l) regulate arbitrageur activities differently than the activities of other market participants.

Market Rumors and Trading Halts: On February 19, 1986, the Commission held a Roundtable discussion on market rumors and trading halts with the Chairmen of the New York and American Stock Exchanges, the NASD, corporations, and other experts. Various participants indicated that trading halts serve an important purpose, but should be held to a minimum, and that corporations that are the subjects of rumors should be encouraged promptly to confirm or deny them. However, denials may be rendered inaccurate by subsequent developments. Therefore, corporations are prone to give "no comment" responses to rumors in order to avoid the need to make subsequent corrections. Thus, some expressed concern that candid denials are inhibited by the disclosures that might have to be made in subsequent corrective statements. This raises the question as to whether there should be a "safe harbor" for responses that are accurate when made, without requiring subsequent corrections as the result of new developments.

On the subject of trading halts, the stock exchanges and the NASD advocated suspension of trading in all markets in a security when the primary market suspends trading. Others favored permitting third marketmakers to continue to trade such securities for competitive and other reasons.

Rewards to Informants: Insider trading and market manipulation cases based on false and misleading rumors typically depend on circumstantial evidence and are difficult cases to prove. Some of the Commission's cases have been significantly facilitated by information provided by informants. The February 19th Roundtable participants discussed whether rewards should be offered to those who provide information that results in successful prosecutions and disgorgements. Some expressed doubts about this approach. Others felt that it would facilitate the effective prosecution of these cases and that it warranted further preliminary review, including analysis of the IRS and the Departments of Justice and Defense rewards to informants programs.

The issues and approaches raised at the February 19th Roundtable are under review.

Questions in Chairman Wirth's Letter of February 19, 1986: The following are specific responses to the questions raised in Chairman Wirth's letter of February 19, 1986, inviting the Commission to testify at this hearing.

Resources and Priorities: As to whether the Commission has adequate staff and other resources to carry out its mission and is setting appropriate priorities:

As indicated on page 14, the Commission has proposed an amendment to its 1986-88 Authorization to include $5.8 million per annum for its internal Edgar processing requirements (*e.g.*, computer workstations, hardware and software). This sum is included in the President's proposed fiscal 1987 budget and the amendment will not require an increase in any appropriations approved or pending before Congress. See pages 14-15 for the reasons for the proposed amendment.

Full implementation of the Edgar electronic disclosure system will increase the efficiency and fairness of the securities markets by accelerating dramatically the filing, processing, dissemination and analysis of corporate information. (See pages 13-14)

The system of selective review and the implementation of the Edgar system will enable the Commission to concentrate its efforts in the areas where review is most needed. (See pages 13-14)

As indicated in the text and the table on page 2, through paperwork reduction, automation and other staff initiatives, the Commission has been steadily increasing the volume and efficacy of its efforts.

Investor protections are being enhanced through increasing coordination of the Commission's enforcement, market regulation, inspection and examination programs with the SROs, state securities commissions and the Justice Department. (See pages 7-8)

SRO electronic intermarket stock and options surveillance systems and transaction audit trails are facilitating detection of market manipulators and inside traders. (See pages 5-6)

The Commission's broker-dealer oversight examination program systematically selects firms with the greatest customer exposure. SRO regulation of member firms is being assessed through compliance inspections of disciplinary and regulatory programs. (See pages 7-8)

Examinations and oversight programs are being enhanced by automated systems designed to detect account churning and to track SRO disciplinary actions and SEC referrals to SROs. (See page 8)

Investment company and adviser inspections are being enhanced through systems examinations of investment company complexes and by targeting high-risk entities, such as advisory firms that handle customer funds or securities.

The Commission is increasing the coordination of its investment adviser inspection program with state securities personnel, to reduce duplicative federal-state efforts and to increase the exchange of information on the results of inspections of dual registrants. In 1985, the SEC staff assisted 16 states in the training of their personnel and conducted 125 joint inspections. (See page 8)

Consideration is being given to proposals for the formation of SROs to supervise investment advisers and/or financial planners.

The staff is analyzing extensive responses to two concept releases 1/ which suggested approaches and solicited comments on ways to facilitate the international mobility of capital and to coordinate and improve international disclosure, distribution, surveillance and enforcement practices. (See page 10)

1/ Release No. 34-21958, 50 Fed. Reg. 16302 (Apr. 18, 1985); Release No. 33-6568, 50 Fed. Reg. 9281 (Mar. 7, 1985).

The staff is preparing a concept release on tender offer issues, soliciting comments on whether to regulate: (i) acquisitions of substantial shareholdings once a conventional tender offer has commenced; (ii) "poison pills"; and (iii) whether to permit corporate self-governance through shareholder-approved charter amendments of certain requirements under the Williams Act. (See pages 16-18)

In the coming year, the Commission expects to emphasize fraud and disclosure violations by reporting companies, violations by regulated entities and associated persons, offering violations, market manipulation and insider trading.

The future offers the prospect of major improvements for the benefit of investors, including the application of telecommunications technology to the high-speed dissemination of corporate information and to the clearance and settlement of securities transactions.

Legislation: As to whether the Commission has sufficient statutory authority to use its resources effectively to protect investors and maintain the integrity of the capital markets, the SEC has very broad authority to discharge its Congressional mandates under the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisers Act of 1940, and the Securities Investor Protection Act of 1970.

Also as discussed in the body of this testimony:

The Commission will shortly submit to this Subcommittee proposed legislation to reduce from ten to two calendar days the filing of initial Section 13(d) disclosures of acquisitions of 5% interests in certain companies.

The Commission has supported repeal of the Public Utility Holding Company Act, 1/ recommended in the President's 1986 and 1987 budgets. 2/ The Commission achieved the objectives of this Act over twenty years ago. Repeal would result in significant savings.

The Commission has supported legislation that would require the banks to conduct certain of their activities through securities affiliates, subject to the same rules and regulations as all other securities firms. 3/

Chairman Shad has testified in support of RICO amendments, which address unintended applications of the Act to common commercial disputes. 4/

1/ Testimony by Chairman Shad before a Subcommittee of the House Committee on Government Operations (Mar. 26, 1985).

2/ The President's Budget of the United States Government, Fiscal 1986 Appendix at I-Y88, Fiscal 1987 Appendix at I-Z109.

3/ Testimony by Chairman Shad before the Senate Banking Committee (Mar. 21, 1984).

4/ Testimony by Chairman Shad before the House Subcommittee on Criminal Justice (Oct. 2, 1985).

ATTACHMENT A

Securities and Exchange Commission
Office of the General Counsel

AMICUS BRIEFS RELATING TO CHANGES IN CORPORATE CONTROL

July 1981 - December 1985

The Commission expressed its views as amicus curiae on various issues relating to changes in corporate control in the sixteen cases discussed below. In eight of these cases the Commission supported the existence of an implied private right of action for equitable relief under the provisions of the Williams Act and discussed the authority of district courts to fashion appropriate relief in such cases. The Commission addressed other issues relating to the regulation of tender offers under the Williams Act in eight cases. One of the latter group of cases also involved issues relevant to proxy contests.

Voisin v. Bartell Media Corp.
(S.D.N.Y., letter sent July, 1981) (letter to district court judge in response to her request for the Commission's views)

> The Commission took the position that the statutory merger at issue in the case was not a tender offer subject to Sections 14(d) and 14(e) of the Exchange Act. The court so held. [1981-1982] Fed. Sec. L. Rep. (CCH) ¶ 98,486 (S.D.N.Y. 1982).

Edgar v. MITE Corp.
(Supreme Court, brief filed July, 1981)

> The Commission argued that the Illinois Business Take-over Act violated the Commerce Clause and was preempted by the Williams Act. The Supreme Court held that the statute violated the Commerce Clause. Three of the six Justices reaching the merits of the case also found that the statute was preempted by the Williams Act. 457 U.S. 624 (1982).

Empire v. Ashcroft
(W.D. Mo., brief filed August, 1981)

> The Commission argued that the Missouri takeover statute was preempted by the Williams Act. The court so held. 524 F. Supp. 898 (W.D. Mo. 1981).

General Steel Industries, Inc. v. Walco National Corp.
(8th Cir., brief filed December, 1981)

> The Commission argued that a district court has authority, in a private action under Section 13(d) of the Exchange Act, to order equitable remedies in addition to corrective disclosure. This case was settled before the 8th Circuit rendered its decision.

Jacobs v. Pabst Brewing Co.
(D. Del., brief filed June, 1982)

The Commission argued that an implied private right of action exists under Section 13(d) of the Exchange Act in favor of shareholders. The court so held. 549 F. Supp. 1050 (D. Del. 1982).

Hanna Mining Co. v. Norcen Energy Resources Limited
(N.D. Ohio, brief filed June, 1982)

The Commission argued that the issuer corporation and its shareholders have a private right of action under Section 13(d) of the Exchange Act to seek equitable relief; that Section 14(e) of the Exchange Act applies prior to the public announcement of a tender offer; and that the district court in a private action can order other equitable remedies in addition to corrective disclosure. The court so held. 574 F. Supp 1172 (N.D. Ohio 1982).

Liberty National Insurance Holding Co. v. Charter Co.
(11th Cir., brief filed October, 1982)

The Commission argued that an implied private right of action for equitable relief exists under Section 13(d) of the Exchange Act in favor of the issuer corporation when it seeks (i) injunctive relief to halt or correct alleged violations of Section 13(d) and (ii) other equitable relief, including divestiture. The court held that a private right of action for divestiture did not exist in favor of issuers under Sections 10(b), 13(d), 14(d) and 14(e). 734 F.2d 545 (11th Cir. 1984).

Sharon Steel Corp. v. Whaland
(S. Ct. N.H., brief filed November, 1982) (on remand from the Supreme Court following its decision in Edgar v. MITE)

The Commission argued that the New Hampshire takeover statute violated the Commerce Clause and was preempted by the Williams Act. The Supreme Court of New Hampshire held, on Sept. 30, 1983, that the statute violated the Commerce Clause. The Court did not rule on the Williams Act issue. 466 A.2d 919 (N.H. 1983).

San Francisco Real Estate Investors v. Real Estate Investment Trust of America (1st Cir., brief filed December, 1982)

The Commission argued: (1) that a private right of action exists under Sections 13(d), 14(d) and 14(e) of the Exchange Act to seek injunctive relief to halt or correct alleged violations of those sections, as well as other equitable relief; and (2) that a district court has authority in a private action to order other equitable remedies in addition to corrective disclosure. The court stated that it did not need to reach the issue of the existence of a private right of action. It adopted the Commission's test on the district court's authority. 701 F.2d 1000 (1st Cir. 1983).

Indiana National Corp. v. Rich
(7th Cir., brief filed January, 1983)

- The Commission argued that an issuer corporation has a private right of action for equitable relief under Section 13(d). The court so held. 712 F.2d 1180 (7th Cir. 1983).

Gearhart Industries, Inc. v. Smith International, Inc.
(5th Cir., brief filed July, 1984)

The Commission took the position that a district court has authority in a private action, under appropriate circumstances, to order traditional equitable remedies, in addition to corrective disclosure, for violations of Section 13(d) of the Exchange Act. The court of appeals agreed with the Commission's position, and also held that a private right of action is available to an issuer corporation to obtain equitable relief for violations of Sections 13(d) and 14(e) of the Exchange Act, an issue not addressed by the Commission's brief. 741 F.2d 707 (5th Cir. 1984).

Florida Commercial Banks, Inc. v. Hugh F. Culverhouse, Sr.
(11th Cir., brief filed March, 1985)

The Commission took the position that the Liberty decision of the Eleventh Circuit should be limited to requests for disgorgement and that to the extent a complaint by an issuer requests corrective disclosure and an order enjoining a tender offer for a period sufficient to allow the corrective disclosure to be considered by investors, the complaint can state a claim under Sections 13(d), 14(d) and 14(e). The court agreed with the Commission's position, but rejected the Commission's suggestion that the holding in Liberty be reconsidered en banc. 772 F.2d 1513 (11th Cir. 1985).

Moran v. Household International Inc.
(Supreme Court of Delaware, filed March 19, 1985)

The Commission argued that a "poison pill" rights plan adopted by Household as an anti-takeover defense would bar all hostile takeovers for Household, would deter proxy contests by Household shareholders, would entrench Household's management, and thus was not in the interests of Household's shareholders and should not be sustained. The court held that the plan would not have these effects and that its adoption by the Household board was a valid exercise of the board's business judgment. 500 A.2d 1346 (Del. 1985).

APL Limited Partnership v. Van Dusen Air Inc.
(8th Cir., brief filed August, 1985)

The Commission argued that the Minnesota Control Share Acquisition Act is unconstitutional under both the Commerce and Supremacy Clauses of the U.S. Constitution. The Commission argued that the Minnesota Act violates the Commerce Clause by imposing an undue burden on interstate commerce and by directly regulating extraterritorial transactions. The Commission also argued that the Minnesota Act violates the Supremacy Clause by contravening Congress' determination, in enacting the Williams Act, not to impose any restrictions on the purchase of securities on the open market other than after-the-fact disclosure of purchases. The Commission emphasized in its brief that it was not arguing that the Williams Act completely preempted the field and that there was no role for state regulation in this area. It was only arguing that this statute on these facts was unconstitutional. On November 26, 1985, the Court of Appeals for the Eighth Circuit ordered the district court to vacate its judgment (enjoining enforcement of the Minnesota Act) after a settlement had been reached by the parties.

L.P. Acquisition Co. v. Tyson
(6th Cir., brief filed August, 1985)

This case involved a challenge to the constitutionality of the Michigan Take-Over Offers Act. Plaintiff argued (i) that the Michigan Act was unconstitutional on Commerce Clause and Supremacy Clause grounds; and (ii) that the target company, whose shares were not registered under the Securities Exchange Act of 1934, had nonetheless violated Section 14(e) of the Exchange Act. The Commission's brief argued that the scope of Section 14(e) is not limited to tender offers for equity securities registered under the Exchange Act. The Commission urged the Sixth Circuit to hold that Section 14(e) extends to fraudulent conduct in connection with any tender offer. The Commission's brief took no position on other issues in the case.

The Sixth Circuit agreed with the Commission that Section 14(e) applied to the tender offer even though the shares were not registered with the Commission under the Exchange Act. The Sixth Circuit held that, as applied to a tender offer not subject to Section 14(d) of the Exchange Act, the Michigan Act did not violate the Commerce Clause but did violate the Supremacy Clause. (No. 85-1640, August 26, 1985).

Hanson Trust PLC v. SCM Corp.
(2d Cir., brief filed September, 1985)

The Commission urged that under appropriate circumstances, major open market purchases by a tender offeror of a target company's shares, made immediately after the offeror terminated its offer could be subject to the Williams Act either because the purchases constituted an "unconventional tender offer" or because the termination of the offer was an ineffective sham, and the purchases thus were a continuation of the original offer. The court held that the purchases in question were not subject to the Williams Act because the shares were purchased from sophisticated traders and none of the pressures on shareholders that the court said the Williams Act was designed to alleviate were present on the facts of the case. 774 F.2d 47 (2d Cir. 1985).

Mr. RINALDO [presiding]. With the indulgence of the Chairman, we will go right into the questions, if you will.

First of all, one of the things we discussed earlier was the relationship amongst the SEC, the SRO's, and the State securities administrators. Has the Commission or have you, as Chairman, given any thought to the notion of explicitly carving out areas of responsibility among the SEC, the SRO's, and the State securities administrators?

Mr. SHAD. That was a specific question actually raised by Commissioner Peters at a roundtable discussion that we had within the past 2 weeks with all of those agencies—the Justice Department, SRO's, the NASD, and others. And the staff is in the process of reviewing this area.

I think we are going to end up coming up with some guidelines which will define the area.

I would like to say, as an overview, the FBI cannot put an agent on every street corner, and neither can the SEC. There are areas of intrastate responsibilities; there are local frauds that should be enforced by local law enforcement agencies. All of these different levels—and it is a pervasive level in my opinion—constitute a pyramid of regulatory and inspection and investigation authority. And we do need to more carefully define these areas of responsibility.

Mr. RINALDO. Do you think that would contribute to better enforcement, and would you like to comment on that, Commissioner Peters?

Ms. PETERS. Thank you, Mr. Rinaldo.

I am not sure that I want to take a position that it would contribute to better enforcement, but I do think it would put us in a position where we would know better where we are and give us a better handle on the referral process.

In that regard, though, there was a comment made this morning—I think by Mr. Phillips, I am not sure—that suggested that the SEC did not know what happened to its referrals. And I believe that is incorrect. We do have a monitoring system, a tracking system, that is overseen by our Division of Market Regulation, that carries through a followup system on every referral that we make to the SRO's.

In addition, I believe there is also a monitoring system to follow through on all of the referrals that we make, that come into our Office of Consumer Affairs.

But, in any event, my suggestion to carve things up would be to make it, I think, a little bit more organized and have defined for others—people other than the SEC, like the State agencies and the SRO's, exactly what was expected of them. And I would think that our referrals would work better.

Mr. RINALDO. Do you think that would better enable you to reallocate any resources to specific areas, if need be?

Ms. PETERS. I think so, because then we would perhaps have more confidence that certain areas are being taken care of, and therefore have more confidence in the reallocation of our resources.

It would make me feel better, in any event.

Mr. RINALDO. Chairman Shad, my understanding is that the SEC does not have the capability to monitor so-called pink sheet stocks, and also has no way of finding out or determining the trading volume in those stocks. Is that correct?

Mr. **Shad**. Not quite. That is certainly an area of concern because it is one of the lowest ends of the securities markets, involving over-the-counter stocks that are not traded in the national market system.

However, we do—from time to time—review and work with the States in bringing enforcement actions against a great number of companies in the so-called pink sheets. And that has been done in past task force efforts. It is an area where we have had task forces if you will, of the NASD as well as the SEC, move on the often referred to "bucket shops" dealing with such securities.

Mr. **Rinaldo**. When you say you have worked with the States, does that mean that in your view it is a State responsibility to enforce transactions in that area?

Mr. **Shad**. To the extent it is intrastate, it is clearly so. But also, there are all the other indicia that relate to those companies. For instance, where are they located? If they are located in Colorado, as the discussion went this morning, the local security commissions do have the authority to take action against the issuers and against the selling agents in cases where we have had some real problems in some of these small pink sheet companies.

So there is a lot of authority at the State level to be brought to bear on the complex that creates and permits markets in these highly speculative securities.

Mr. **Rinaldo**. Let me take it a step further. If a particular State is not taking very active or very effective action in this area, then really there would be no active enforcement at all in the absence of any enforcement by the SEC, is that correct?

Mr. **Shad**. I cannot say that, because actually there are issues that are the responsibility of the self-regulatory organizations. The NASD sometimes is directly involved in supervising and sanctioning the firms that promote such issues, the salesmen and the other people.

So we have a pervasive regulatory system that does, in fact, get down to the lowest end of the market.

Mr. **Rinaldo**. Would you say there is any more fraud in that low end of the market than in the rest of the market, based upon percentages? In other words, is the amount of fraud attributable to that low end, in your opinion, greater than the fraud at the upper levels of the market?

Mr. **Shad**. I think—and I do not have the hard facts—but my impression would be that, in terms of numbers, probably yes. In terms of dollar volume, I would not be so sure. We classify many of our enforcement actions as fraud, but when we require a major corporation to restate its prior inadequate financial statements even if we don't charge fraud, that has an effect on hundreds of thousands of investors in that company.

So balancing off the impact of major enforcement actions against the lower end to the bottom of the market, I think the dollar volume would be much greater on the larger precedential type of cases we bring that have an influence across the board.

Mr. RINALDO. I understand your answer. The dollar volume would be higher at the upper levels, but the number of cases or percentage of cases greater at the lower end.

Now does any Commissioner or do you feel that anything more should be done at the lower end? Do you need any additional legislation, any additional resources or anything else to make enforcement at that lower level more effective. Or do you think there should be something that the States should be doing to make it more effective, because there have been numerous cases where people have been bilked out of life savings as a result of a very definite and proven instances of fraud at that lower end?

Mr. SHAD. I do not believe we require more legislative authority. I think we have pervasive power, if you will. We are steadily trying to upgrade the quality of our surveillance and enforcement activities. I think a better job can be done through better coordination and utilization of resources of the multiple investor protection facilities.

Let me mention one number that has floated around, but that did not get ventilated this morning. The State's fees that they receive amount to about $120 million. They spend, on investor protection, about $40 million. Their surplus is about $80 million, or three times what they are spending on law enforcement.

I think that more needs to be done in that area. I appreciate that they are under severe budgetary constraints, that securities fees are looked on by most States as a source of revenues. I think we could be more effective in utilizing more resources at the State level, and at the SRO level. I found a very practical and probing inquiry by the subcommittee this morning as to the practicality of directing more resources under the Federal level.

I mean, I do not think some suggestions are very realistic in terms of our access to a lot more money in these Federal budgetary circumstances.

But I think a much greater portion of State revenues from security fees could be more effectively utilized, as well as more reliance on the SRO's.

Mr. RINALDO. Thank you.

My time is just about up. I would like to ask you one quick question for the record. How many cases—I read the statistics we had including the comparisons between 1981 and 1985 which indicate the type of job the SEC is doing. But how many cases, in both upper level and lower level categories, were referred by the SEC to the Justice Department for criminal prosecution, as opposed to civil matters?

Mr. SHAD. I cannot give you the number of referrals, but I can say that 83 criminal securities actions were brought by the Justice Department last year. It is a record. I think it is a record level.

Our staffs have been working closer together.

I also would like to mention a number that was bandied about and has been included in various places, the large increase in the volume of trading. It is true that the volume of trading has increased by 133 percent since 1981. But what has happened is, the volume of transactions, which is a much more relevant number in terms of our surveillance, is up about 38 percent. And our enforcement activities, the number of cases brought, inspections, and all, are up more than that.

So, if you take into account, in effect, the increasing institutionalization of the securities markets, our ability to survive has not been out of proportion to the increase in transactions.

Mr. **Rinaldo**. Thank you very much.

Mr. **Wirth**. Thank you, Mr. Rinaldo.

Mr. Shad, on the first panel, one of the panelists said we are in the midst of an epidemic of securities fraud, and a second panelist said in 25 years, I have never been more concerned about the ability of the Commission to promote disclosure and enforce the securities laws.

Those are my paraphrases. They may not be exactly right, but they reflect notes that I took.

I think it is appropriate that you have the opportunity to respond to some pretty strong statements.

Mr. **Shad**. Well, I think the subcommittee did a good job of probing for the facts, which were very shallow, in terms of the support of that "epidemic"-type statement. I could provide a few facts.

Complaints have been mentioned, which is an indication of problems. Between 1981 and 1985 they increased from 21,000 to 31,000 per annum, which is a 47-percent increase. Again, that compares with a 39-percent increase—I said 38 a moment ago—a 39-percent increase in the volume of New York Stock Exchange transactions, as distinguished from share volume.

In 1982, the SEC staff installed an automated system with respect to investor complaints. First, the complaints are reviewed as they are received. And then there is an automated system to track them through resolution. So it is not the case that these thousands of complaints pour in and are just forgotten. They are referred to the firms which are asked to provide a written response. The industry wants these kind of problems to be dealt with. They want customer satisfaction and confidence. It is not something that is being ignored, by any means.

Presently 26 percent of the 72 investigations that are in process are a product of the public complaints that we have received. Most of those complaints, I would hasten to add, don't involve fraud. They are made by single investors concerned over back office problems. For example, they did not get a dividend check.

And those are very important problems, but they do not rise to a Federal enforcement action.

We also bring to the attention of complainants the binding arbitration rights that they have with the SRO's. Last year there were about 3,000 binding arbitration proceedings with the exchanges and the NASD.

I gave a longer answer than I should have, perhaps, but I do not know of evidence or facts that would support allegations of an epidemic relative to the size and nature of the markets today.

Mr. **Wirth**. Let me ask other members of the Commission if they have any response to those statements made this morning. Mr. Cox.

Mr. **Cox**. I listened, with interest, Chairman Wirth, to the previous panel when those assertions were made, and I would like to respond that I have seen articles alleging approximately the same thing. One thing that I have done, in concern about such claims, is to speak with the Director of the Division of Enforcement and ask him in a very straightforward manner: Are there cases that are being shucked off, ignored, and so forth? Are there viable securities violation cases that the Division of Enforcement is not pursuing?

And I have been assured, when I have asked, that is not the case. At the Commission level, we very seldom turn down a formal order, but I was concerned that cases might not be getting even that far. My investigation of the staffing and of the workload in the division says that there are not cases being ignored.

Thank you.

Mr. WIRTH. Ms. Peters.

Ms. PETERS. Thank you, Mr. Chairman.

I would like to address myself to the 31,000 complaint figure. I think it is important to understand the types of complaints included in that figure. Our annual report breaks them down among investor disputes with broker-dealers, complaints concerning issuers, complaints concerning mutual funds, and then the remainder—which is about 32 percent or so—concerning transfer agents and basically back office compliance problems.

I think that if you look at those numbers, it would be hard to say that there is an epidemic of fraud. I have to acknowledge that there has been increased activity in the market; there are more transactions.

There certainly would follow, logically, an inference that there may be more fraud involved in those transactions. But to use the word "epidemic," seems to me, to say that the fraud has reached outsized, unmanageable proportions. And I do not think that the figures that are being collected by our Office of Consumer Affairs support that. And we collect those figures and they are available to us. I get them on a monthly basis.

Mr. WIRTH. Mr. Chairman, as a general proposition, it seems to me that we on the subcommittee—with some difference in emphasis--have generally agreed with you in the pursuit of the goal of investor confidence, and the need for strong enforcement as a central goal of what the SEC ought to do.

We might have disagreed on the margins as to how much ought to be done and what the size of your budget ought to be and so on. But for the most part, I think we have all agreed as to what should be your central direction.

What increasingly concerns me is that these financial markets are changing so very, very rapidly.

And the question keeps coming up as to whether or not we are doing an adequate job, you at the SEC and we in the Congress, of changing policy and changing legislation and changing the way in which we deal with our financial market to keep up with these changes.

For example, do we have the capability to understand and keep up with the increasing internationalization of the marketplace. You and I have discussed that briefly before. Here is an enormous and looming area that really changes the nature of our markets. How do we go about making sure that American securities laws apply to the trading of securities in London? Well, of course, we cannot do that.

What happens with 24-hour trading and trading in Hong Kong. How do we effectively deal with the proliferation of new instruments that we see, whether those are high yield bonds or options on securities or whatever they may be. Do we understand the implications of those? And do we have the capacity to oversee those?

I can think of a third area where we have the overlap of instruments between agencies. You will remember many discussions of the SEC versus the CFTC and the SEC versus the banking agencies. How should we regulate instruments and institutions that once were separate, and distinct, but with respect to which the lines are increasingly blurred.

I raise all of those kind of very broad long-term questions. We have agreed together on the importance of investor protection and the importance of people having confidence in the markets.

And the question becomes, What are we going to do next? Do we have the capability of looking at these? Should we be more aggressively doing that? Should there be some kind of a joint effort between the SEC and the subcommittee to look at these new areas?

This is more of a semantic than a specific set of questions. But looking down the road, 3 years, 5 years, 10 years from now, are there areas that we should be addressing today that are going to be coming back, perhaps, to haunt us in the future?

Mr. SHAD. Well, I think those are very important areas, every one of them. There are a few others that we would include on the list, all of which are under active Commission review and study and action. We are bringing cases internationally, and we are successful.

We just obtained the largest disgorgement we have ever received on an insider trading matter in the *Sante Fe* case, where the defendants were shielded by the Swiss secrecy laws. The courts have been helpful to us.

I could go through each one of these with a litany of all of the ongoing efforts and effective actions by the Commission. But I also agree—and the suggestion has been so frequently mentioned—that we could, of course, do more with more. I do not think it is a realistic suggestion——

Mr. WIRTH. Let me go back to internationalization. We have a marketplace that is changing very, very dramatically.

Mr. SHAD. Well, I could respond with some facts in that area.

First of all, the SEC in 1982 obtained an accord with Switzerland to remove the haven of the Swiss secrecy laws from insider traders. It was a precedential event. We have worked with the Hague Convention in certain areas. We have created the Office of International Legal Assistance to pursue these cases.

The best means of pursuit in many cases is to grab the assets here that are involved in illegal transactions. There have been important court decisions that if you play in our markets you have to play by our rules. And the courts have enabled the SEC to go in and or freeze assets and then proceed with the enforcement proceedings. We are doing those things.

Admittedly, the international markets are growing rapidly. International transactions are about 10 percent of the volume of transactions on the New York Stock Exchange today.

There are presently 325 companies whose shares are traded in more than one country. I believe that in a year or two there will be a multiple of that, through the linkages that are now being created. And we do have control when those transactions reach the States.

We have a problem with the foreign secrecy and blocking laws. They are a real problem. And as a consequence, we have put out two major concept releases. We have been in a round of conversations, and there is much more to come in that area, in terms of how to work with other law enforcement agencies abroad, how to coordinate our efforts, as we are also doing domestically.

Mr. WIRTH. Ms. Peters.

Ms. PETERS. Mr. Chairman, I think that we are focusing on the internationalization process of our markets. I think that we at the Commission are definitely focusing on it. I know that I am, as a Commissioner, as are the other Commissioners and the staff.

We have been looking at these changing markets and, I, for one, for my part, am trying to focus on those changes as they relate to the changing market structure here in our own domestic markets. And right now the staff is reviewing and analyzing—they have already summarized—but I think they are in the process of analyzing responses to the two international releases that we sent out.

Along with that we are conducting discussions and are in contact with other international regulators. I think that at this point it is maybe too soon to say to you, we need some additional legislation to help us deal with this ongoing process. But I think that once we have finished our analysis and our brainstorming, so to speak, we should be able to give you a more definite opinion on what approach might be necessary to deal with the internationalization process.

Mr. WIRTH. I appreciate that. And I realize that this is a novel area and we are just getting into it.

The reason that I raised these four or five areas of concern is that it seems to me that these are on the leading edge of the financial policy, public policy frontier. We are going to have to make some changes in existing law. We are going to have to make some changes in the way you staff and look at these. Nothing remains static, nor should it. And I think we rejoice in the fact that there is a lot of growth and change.

But as we do that, I think that we count upon you to come back to us with recommendations. Because we happen to sit with Gramm-Rudman, or whatever it may be, does not mean that we cannot and should not have a clear and honest discussion about what needs occur. There may be a real crisis brewing out there, and the involvement of some very, very good people at this point might change that. I know you are aware of this, Chairman Shad.

Let us remember that the primary goal that we have here, it seems to me, is assuring that the American public is well served by our financial markets. That is our goal, and we do that in part by precluding fraud and insider trading and so on. But we also preclude it by understanding where our markets are headed and moving in a very thoughtful fashion.

I would not like to leave you with the impression that members of the subcommittee do not want you to be coming back to us, if that is appropriate and necessary, saying, we have to change our policies in this way, or we need more resources, or we have to have new legislation. That is your job, and I do not think that you can be diverted from that chore from what may be the fashion of the day.

Mr. SHAD. Mr. Chairman, I would like to interject that there are other areas that I think are proportionally important that we are pursuing.

For instance, with the Ginnie Mae settlements, I think we could have serious problems in that area because it is on a manual basis, and it is billions of dollars on closing dates. It is not an area of our direct jurisdiction, but we are assisting.

We are planning to have some meetings with the key people involved to facilitate this idea we have been pursuing for the past 2 years now of immobilization of security certificates. That is an enormous area with billion dollar benefits for the investing public, as well as problems avoided in the way of this paperwork blizzard. And more tonnages of securities are being put into the marketplace every day. This is a huge area.

Also not mentioned this morning were rumors. We have had special roundtable discussions on how to deal with these volatile markets on false and misleading rumors. Is it manipulative?

We are reviewing programs to get better responses out of the corporate community than "no comment"-type responses. We are considering things such as rewards to informants with the precedent of the IRS and others to look to.

So that there are a lot of other important areas that we are sensitive to because it is our all-day-long, 24-hour job, and I do not think that some are aware of these things. And they are equally as important as any that have been mentioned this morning.

Mr. WIRTH. I will start the rumor immediately, Mr. Chairman, that you are coming back for your 14th appearance very shortly, and that will settle down the markets and make them very, very sober in thinking about that.

Mr. Luken.

Mr. LUKEN. Thank you, Mr. Chairman.

I want to assure you, Chairman Shad, and the other members of the Commission, that we are interested in your opinion, and we will not require hard evidence to back them up, and we will not suggest that they are hearsay, because you are experts in this matter. And I noticed that you have been offering your opinions and they have been accepted. We will continue to do that.

I would like to get into the—just discuss with you generally—this question of the use of limited resources. I do not think it is an issue of whether we want to advocate additional user fees today. Mr. Tauzin made the point that the administration is not reluctant to recommend user fees, despite its unwillingness to recommend other forms of tax increases.

But the question, would you agree, Mr. Shad, is whether we are using our limited resources to the best avail in maintaining investor confidence in the markets? Is that a fair statement? Or would you like to elaborate on that?

Mr. **Shad**. I believe that. But I was also pleased to note the support of even people who do have critical suggestions—that they concur in that view, by and large.

Mr. **Luken**. I think we can agree on the principle. And we can also join in the praise that has been offered by those people who had other criticisms, that the caliber of work, caliber of product that is being put out by agency today.

But, as a matter of fact, since you have announced that you are going to return about $50 million a year more than you spend of the fees that are taken in, we are not right at the moment facing any need for increase in user fees, are we? There is still some room in there to operate where you would have more to spend.

Mr. **Shad**. It is not quite correct to divide that $100 million by two. It will be higher in the second year than the current year. But, in any case——

Mr. **Luken**. Well, we can look forward to the future. We have great vision.

Mr. **Shad**. All of our fees, personnel and budget, are set by Congress. And the fees go directly to the Treasury. And I think that OMB and the President, they take that into account in their budget.

Mr. **Luken**. Well, Commissioner Peters observed that we could expect more fraud from more transactions. Is that not right? And that is what has happened.

Ms. **Peters**. Well, in absolute figures I think that that is a logical inference. My point was that I do not think that that translates into an epidemic unless you can demonstrate that percentagewise there are more fraud complaints as compared to any other type of complaint.

Mr. **Luken**. Right. But I am just trying to be logical. It does not describe an epidemic, but it might call for more resources to detect that fraud and to prosecute the perpetrators, and to weed out that fraud from the process. That is what I would suggest.

And then, going one step further, Mr. Shad, you indicated that we could do more with more. We could do more what?

Mr. **Shad**. Enforcement, review, all of our various areas of responsibility.

Mr. **Luken**. Do you think we should?

Mr. **Shad**. I would suggest this. I think the incremental return on the additional effort would not be as great as the bang we are getting for the buck now.

Mr. **Luken**. If we agree to that. It does not answer the question though, does it?

In the line of protecting consumer confidence or investor confidence in protecting those investors and carrying out the laws and maintaining this incredibly good market that we have to spend some—I do not want to say a few more million. That might not sound too good. But to spend some more millions of dollars in that effort——

Mr. **Shad**. It is in the President's budget for fiscal 1987 to increase us to $110 million from the Gramm-Rudman level of $106 million, and also add personnel over the Gramm-Rudman level.

Mr. **Luken**. Well, for example, as far as Gramm-Rudman is concerned, would you agree with me that your agency, like the IRS, like Customs perhaps, should be looked at a little differently than others under Gramm-Rudman?

Mr. SHAD. You are at a policy level. I believe the committee or the subcommittee——

Mr. LUKEN. We would like your opinions though.

Mr. SHAD. A majority of you have supported Gramm-Rudman. I cannot qualify that judgment.

Mr. LUKEN. Well, we qualify——

Mr. SHAD. I do not have a basis for it. But I can say this: that the administration has put the SEC into somewhat of a special category in the administration's—the President's fiscal 1987 budget, because we are a law enforcement agency. And I think those areas are being acknowledged, as with the FBI and others.

Mr. LUKEN. Well, referring again to this morning's discussion. The figures we were talking about this morning with Mr. Phillips and in general were based on a period of time from 1975 to 1985. And your figures, for the most part, go from 1979 or 1981 to the present.

Mr. SHAD. 1981 to 1985.

Mr. LUKEN. To the present time. Well, your budget goes from 1979 to 1985. And they do reflect an increase in complaints by 97 percent. I think the 1975 to 1985 figures would show an increase above that.

Would you want to comment on the difference in those periods, any explanation of why? Do you agree with Mr. Phillips' figures that he offered this morning?

Mr. SHAD. Well, I think the basic figures are right although I have not specifically checked them. But I can give you better comparative data on 1981-85 because that has been my term on the Commission.

Mr. LUKEN. Well, you have a certain pride of authorship there.

Mr. SHAD. Well, I am not sure that it is authorship. It is just that you tend to look at——

Mr. LUKEN. Stewardship. But in any event——

Mr. SHAD. I want to hasten to add, I think that Harold Williams and the prior Commissions were excellent. They did fine jobs with the resources and the problems they had to deal with.

I do not want to suggest that we are doing something that is extraordinary beyond what has been done in the past. The staff goes on while the Commissioners change. And the ongoing productivity improvements are a long-term trend within the SEC.

Mr. LUKEN. Well, it was noted that, for example, in 1975 the Commission brought a total of 316 actions and proceedings in which 749 defendants were named. But in 1985, the Commission instituted only 268, naming 391 persons.

Mr. SHAD. I think if they were quantified in dollars that the present cases would be a multiple of those. Not in number of cases, but in significance, materiality. That would be a separate——

Mr. LUKEN. Well, I am not going to ask you if you have any hard evidence to back that up because we accept your testimony as an expert. And we recognize there may be disagreement among experts in that regard.

But on the subject of looking at the 10-K's, for example. We had testimony that just as recently as 10 years or so ago all of the 10-K's were looked at.

Mr. SHAD. I do not think that is accurate. They had a category called disposed of, which I do not think meant that they were getting thorough review by any means.

Mr. LUKEN. Well, we would like your opinion on what was happening 10 years ago then. Are you looking at fewer of them than 10 years ago?

Mr. SHAD. I think we have developed, over the 10-year period, very sophisticated, much better means of identifying those which require thorough review. There has been specialization within the Corporation Finance Division, as well as use of new and better techniques, data bases, external sources to identify companies that are likely problem situations. It is a lot better than it was 10 years ago.

Mr. LUKEN. Well, you do not review all of the disclosure documents. You have a selective review procedure. That is what you are speaking of, right?

Mr SHAD. Yes.

Mr. LUKEN. Now the members of this committee have been concerned that the Commission might be losing ground in its efforts there. With respect to the documents you do review—20 percent——

Mr. SHAD. 22 percent.

Mr. LUKEN. 22 percent. Well, in 1983 your review process picked up 180 matters for referral to the Division of Enforcement. In 1984 only 94 matters referred to Enforcement. That is rather a substantial drop in a couple of years, and it may be selective. I would like your comments on that.

Mr. SHAD. The decline in the referrals?

Mr. LUKEN. Yes. Would that not be a pretty good barometer of enforcement level?

Mr. SHAD. Not necessarily. You know, I would like to provide you with some hard facts.

Mr. LUKEN. I mean, might it indicate that the staff is not going over the documents quite as carefully or as exhaustively?

Mr. SHAD. Between what years are you referring to?

Mr. LUKEN. 1983 and 1985. I am not trying to rush you.

Mr. SHAD. No; the percentage of 10-K's reviewed has been increased since then.

Mr. LUKEN. Since when?

Mr. SHAD. Since 1983.

Mr. LUKEN. Well, I understand. But the enforcement—I am suggesting the dropoff in the number of matters referred to Enforcement. I am asking what you think about the possible significance of that.

Mr. SHAD. Referrals to Enforcement. Let me ask Mr. Huber, the head of the Corporation Finance Division to specifically respond.

Mr. LUKEN. That is what we are looking for, information and opinions.

Mr. HUBER. Congressman Luken, the 180 figure included not just enforcement referrals but information memoranda that did not recommend enforcement action, as well as request for distribution surveillance with respect to IPO's. And if you look at 1983, we had approximately 1,400 IPO's. It was a very heavy market with respect to IPO's that we have not seen in terms of those levels since.

Mr. SHAD. IPO's are initial public offerings.

Mr. HUBER. In 1984 we discontinued the information memos and went to a straight enforcement referral system. And I think the figures you should be focusing on, with respect to your question, sir, are the figures of the amount of acceptance by the Division of Enforcement of the recommendations by Corportion Finance.

In 1983 they took 49 percent of our referrals. And in 1985, they took 65 percent of our referrals. The coordinative effort between Corporation Finance and Enforcement with respect to the types of cases that they are interested in, and the type of cases that we find for them and refer to them is at a higher level today than it was 3 years ago.

Moreover, the impact of the review process has had substantial results short of an enforcement referral. In fiscal year 1984 we wrote 4,131 comment letters and had 2,000 amendments to filings. Amendments to filings are done pursuant to my division's authority to request changes. In fiscal year 1985 we had 5,800 comment letters resulting in 2,200 amendments.

And I might point out, with respect to the Home State filing that you mentioned earlier, the disclosure with respect to the risk and the principal versus agent relationship between ESM and Home State was the result of a comment given by our staff and an amendment to that 10-K. And that is the reason why that disclosure was there.

Mr. LUKEN. Would you repeat that?

Mr. HUBER. Pardon?

Mr. LUKEN. Would you say that again? You gave us a lot of new figures here. What was your last statement about Home State?

Mr. HUBER. On the Home State 10-K that you referred to earlier that was in the marketplace, the reason why the risk disclosure was there, with respect to the principal versus agent relationship between Home State and ESM, was because the Division of Corporation Finance had them amend that 10-K to give the full disclosure.

Mr. LUKEN. That is the reason. Does that have some bearing on my comments? Do you think it——

Mr. HUBER. The reference that you made, sir, was that we did not handle the Home State 10-K. Not only did we handle it, we were responsible for having the disclosure change, which is what I told you last year when we testified.

Mr. LUKEN. But that was not effective in any way, as far as having them unwind those transactions which you looked at. And now a grand jury in Ohio has looked at the same transactions and indicted two people for felonies.

Mr. HUBER. All we were trying to do was to get the disclosure into the marketplace, sir. That is our job, disclosure.

Mr. LUKEN. Your job is disclosure. The point that I was making was not to criticize you for not bringing in indictment. The point that I was making, with the disclosure at the various agencies, between the State and the Federal agencies, no one picked it up. There was not any—it was all there before everybody, was very publicly disclosed. But no one blew the whistle for a number of years, even though it was publicly disclosed.

I made no charge when I referred to these incidents, to these facts. I made no charge that SEC should have brought the prosecution. That was not my point at all.

Mr. **Huber**. Thank you very much, sir.

Mr. **Luken**. I am glad you made that correction or that clarification of the record. That was not my intention.

But if we go into the ESM situation, ESM-Home State—particularly the ESM situation, here was a Government securities dealer that never made a dime, that continued to operate in a positive scheme for 10 years because it was unregulated. It was not monitored by anybody.

Your good officials in Florida attempted—perhaps through a subterfuge—attempted to blow the whistle on ESM and was prevented because of the lack of implementing legislation, of legislation that would permit them to supervise.

Now we have, not with any assistance from the SEC, we have at least passed through the House a set of regulations which—of legislation that would bring about regulations which might prevent that in the future. If we want to get down to cases as to where—what we have done about that.

The House has, over the objections of the chairman, as I recall—you can correct me if I am wrong.

Mr. **Shad**. I do not agree with that statement, sir.

Mr. **Luken**. Did you agree with—do you endorse our Government securities regulations?

Mr. **Shad**. No; we have not. But, I think that you were assisted by the very detailed analysis prepared for this subcommittee at your request by the SEC, in conjunction with the Treasury and the Federal Reserve Board.

We have—and with a possible legislative approach suggested virtually all the major points of which were incorporated in H.R. 2032.

The only exception, I believe, of any materiality was the suggestion of establishing an additional SRO with some rulemaking authority. The other proposals include substantial rulemaking authority, either by the Treasury or the Federal Reserve.

So I think that the substance of the bill that the House has passed came from within—the Commission or at least maybe independently. But in any case, you had the benefit of our analysis.

Mr. **Luken**. Well, I am very happy to have that clarification also. And I was not suggesting that you were not helpful in the mechanics and the expertise in developing the legislation.

But I did get the clear impression when you were here before, you were not in favor of that legislation.

Mr. **Shad**. The SRO portion; that is correct.

Mr. **Luken**. But in winding up—I think I am running out of time here. I was developing a line of questioning here which really was based upon Chairman Shad's testimony in 1983 with reference to the number of enforcement referrals, in which the Chairman said that that was a good measure of the disclosure review program.

Now I think I rather innocently got into this. I was comparing apples to apples, not apples to oranges, I did not think. And now you have said you have changed the rules of the game on us so that we can no longer look at the number of enforcement referrals, as the Chairman suggested, as a measure of the disclosure review program.

Mr. SHAD. I think that the director of the division has pointed out that we are getting a better response to those referrals.

Mr. LUKEN. Maybe better, but different.

Mr. SHAD. Much higher.

Mr. LUKEN. And one that confuses us no end. And I think without our fault.

Mr. SHAD. Well, the process we are going through is to try to steadily upgrade the effectiveness of our efforts. And I think that what Director Huber pointed out was, they are more effective, notwithstanding a lower level.

Mr. LUKEN. That may be, but you do not act in isolation. We are all in this together, and you gave us a good indication—you said, a good measure, and then you change the rules of reporting so that we are going to have to do—based on what you say, you may well be correct. But based on what you say, we are going to have to do a new analysis, right? A comparison.

Mr. HUBER. It continues to be one measure, Congressman Luken. Other measures are the numbers of amendments that we get pursuant to comments rendered on filings. And also the——

Mr. LUKEN. And I suggest that the comparison of enforcement referrals is meaningless based on your statement.

Mr. HUBER. No; I did not say that. I said it was one measure.

Mr. LUKEN. It is one measure.

Mr. HUBER. And it continues to be a measure. And what I am saying to you is that——

Mr. LUKEN. And we are going to have to adopt—we are going to have to amend that with reference to the new ground rules that you have rather quickly and copiously given to us. And we will have to look at it and get back to you.

Mr. LUKEN. Thank you, Mr. Chairman.

Mr. WIRTH. Thank you very much. Mr. Oxley.

Mr. OXLEY. I yield to the gentleman from New Jersey.

Mr. RINALDO. Thank you. After the exchange between Chairman Shad and our colleague, I thought it might be a particularly appropriate time to bring to the subcommittee's attention that Chairman Shad now holds the record for SEC tenure as chairman, and is the first ever to complete a 5-year term.

I also want to take this opportunity, since I have to leave in a minute for another meeting, to welcome the newest member of the Commission, Mr. Edward Fleishman from my home State of New Jersey, who is making his first appearance before the subcommittee today. Mr. Fleishman, I, along with my colleagues here, certainly wish you every success during your tenure on the Commission. And I want to thank all of the members of the Commission for their input here today. I am sure that it will be very helpful.

Thank you.

Mr. OXLEY. Thank you. Mr. Shad, what effects, if any, has the Insider Trading Sanctions Act, that passed in 1984, had from the SEC's standpoint in terms of enforcement?

Mr. **Shad**. We only bring cases under the Insider Trading Sanctions Act which came after August 1984. Insider trading cases are very resource intensive. They are built largely, if not entirely, on circumstantial evidence, and they often involve investigations of a year or more for those reasons.

In 1985 we brought two cases and recouped $150,000 in fines beyond the disgorgements. This year to date, we have filed three actions under the Insider Trading Sanctions Act, and have several that we expect to file within a few weeks. So you are now seeing the buildup of this effort.

And I believe that the act has significantly modified the risk-reward ratio on this type of activity, and that it should have a significant inhibitory effect as you get more of these cases ventilating the severe consequences to insider traders.

Mr. **Oxley**. So, in a word, it has been effective.

Mr. **Shad**. Yes.

Mr. **Oxley**. And for that I think the chairman of this subcommittee deserves a great deal of credit for his leadership in that legislation, which really emanated from this committee. And we are pleased to see that those changes in the law have been effective and continue to be effective throughout the years.

While we are on the area of enforcement in general, you made the comment that you were considering rewards for informants, not unlike the FBI and the Bureau of Alcohol, Tobacco and Firearms and other Federal agencies that do pay informants. Do you think you need congressional approval for that, or can you do that on your own?

Mr. **Shad**. It is moot at this moment. There are various ways to structure rewards, such as by SEC recommendations to the court, for example, to set aside funds to informants out of the disgorgements. This issue is at a very preliminary level of review. It is an idea that might be especially useful in responding to these rumors in the marketplace, if they are for the purpose of manipulation, to get people to come forward and tell us.

Our problem is, we get enormous numbers of leads from the SRO's and others, and you have to winnow through all those to come up with hard leads, solid information to justify a commitment of major resources.

Mr. **Oxley**. I take it, though, that the financial rewards would be to individuals as opposed to SRO's or another entity; is that correct?

Mr. **Shad**. Yes; the thought has been to individuals.

Mr. **Oxley**. Mr. Shad, this morning on the panel before you, I think Mr. Griffin said—at least I perceived him to say—that the SEC will not furnish information to State authorities unless that information is available to the public under the Freedom of Information Act. Was that a correct statement?

Mr. **Shad**. I do not feel comfortable with that statement. I would like to ask Mr. Lynch, the head of the Enforcement Division, to amplify it.

Mr. **Lynch**. I was very surprised to read that statement in the testimony and to hear Mr. Griffin make that statement this morning. I have never heard a State agency complain of that before, and I have had a number of meetings with State representatives.

In 1985 alone, in just that 1 year, we made our files available to State regulatory authorities in 148 cases. And in the first quarter of this year—that is October 1 through the end of December 1985—we made our files available in 45 cases. So I am not aware of any major impediment to making our files available to State agencies when we have formal orders available.

The one area where there is a little bit of difficulty is if we have documents in our file that we have gathered under the Right to Financial Privacy Act. And because of the Right to Financial Privacy Act, if we give those documents to a State agency we have to go through certain hoops in order to do it.

So there might be a delay if RFPA documents are involved in a State agency request. But in the overwhelming bulk of requests, we process the request promptly. And I am not aware that there is a major problem.

Mr. **Oxley**. OK. Thank you. Mr. Rinaldo, who had to leave, requested that I ask a couple of questions. Mr. Shad, how would you rate the performance of the SEC-CFTC accord, and what, if any, problems have been encountered?

Mr. **Shad**. I think it has worked well. The volume of trading in financial futures since the accord—in other words, within the CFTC's jurisdiction—has increased dramatically.

And the SEC does have an effective oversight role. Any new futures on stocks or stock indices are subject to the SEC's approval because we do have jurisdiction over the underlying instruments. And it has worked well. The two staffs are working well together.

Mr. **Oxley**. In what areas, if any, do you see a need for greater normalization between the regulations and requirements of the SEC and those of the CFTC, or is it too early to determine that?

Mr. **Shad**. No; there are areas where it would be helpful to have a greater conformity. Particularly, I believe the Commission in the past has indicated that these instruments ought to compete on their economic utility and merits, rather than their margin regulations. And there is a different structure for setting the margin regulations between options under our jurisdiction on financial instruments and futures on financial instruments. That is one area.

Mr. **Oxley**. And how could that be changed? Does that require legislation? Can it be done through a cooperative effort between SEC and CFTC?

Mr. **Shad**. I think the Federal Reserve Board has raised the question of whether there should not be a small committee of representatives of the SEC, the Federal Reserve Board, and the CFTC to coordinate and supervise the margin regulations. This change would, basically, put regulatory authority at the exchange level, which it is, in the case of the futures markets. It is not in the case of the stock markets.

But put it at the market level where the SRO's are more sensitive to what is going on, and have SRO regulation subject to, however, an oversight by a combination of the three Federal agencies, in order to avoid a competition to reach the bottom of the regulatory barrel, in terms of the financing of these transactions.

Mr. **Oxley**. Thank you. Thank you, Mr. Chairman.

Mr. **Wirth**. Well, Mr. Chairman, we greatly appreciate you being here. There has been a lot of discussion this morning about numbers and enforcement and so on. Perhaps I could close with just a general question.

Can we assume that there is enough oversight and concern and enforcement to keep up with the growth in the markets that we talked about before, and the increase in the number of broker-dealers, and the proliferation of instruments?

Can we assume that you have enough capability, both financially and legislatively, to assure that the rumors that we hear from time to time that deals are being done that would never have been dreamed of before, because of the low oversight that you can conduct? Are those rumors unfounded?

Mr. **Shad**. I think we have—the word that comes to mind is pervasive—overall regulatory authority over the markets and the self-regulatory organizations. You mentioned new financial instruments. Let me just give you one little comment on that.

Whenever somebody files an offering involving a unique or novel type of security, those get 100 percent review. These new emerging devices are very carefully reviewed by Corporation Finance. So it is not as though there is a whole lot of new things pouring into the marketplace that we are oblivious to. That is not at all the case.

As to whether we can do a better job in terms of oversight, I think that there were some constructive suggestions, in particular by GAO this morning, that warrant our careful review. And I think most of these areas the staff is keenly sensitive to. But we have an open mind. We want to do a better job.

Mr. **Wirth**. There is a gnawing concern that perhaps you cannot be as watchful as you might have been in the past, and maybe some of that is endemic to the marketplace which has grown and changed so dramatically.

I hear it from people on a steady basis. We have a very fragile marketplace out there.

Mr. **Shad**. The markets are not fragile. They are the broadest and strongest, in terms of fundamentals, that they have ever been. There have been serious problems; there is no question about that. But on the idea of fragility of markets, the studies are quite to the contrary.

And as to their volatility. I mean, you see headlines that the market broke 39 points in 1 day. Percentagewise that is a fraction of prior—of previous market reactions.

It would be a very serious mistake if a public perception came out of these hearings or other sources that the markets are rampant with fraud, and that there is an epidemic out there, or that there is something extraordinary that is out of proportion to the size and nature of these markets. That is just not true.

Mr. **Wirth**. I appreciate you saying that. You are the public official most responsible in that area and I wanted to have the opportunity for you to make that as kind of a closing statement on the discussions of today.

Mr. **Shad**. I would like to add one thought. Markets go down as well as up. And I do not want, by any means suggest——

Mr. **Wirth**. We all get older too, do we not?

Mr. **Shad**. And when you do get a bear market—and some people think we are moving into the third stage of a major bull market. When you get a blowoff, when you get all these hot new issues coming out as we have had in previous bull market tops, and then a break, it can be most dramatic. And it can bring out all kinds of litigation. Because it is at that point that the securities bar and investors go back and pore over these filing documents to see if there was any false or misleading information or material omissions in their filings.

So that if you get a serious bear market, there is going to be a lot of litigation and I would say the SEC will be going to the battlements and in the fire brigades to respond to the problems that a bear market brings out in the marketplace.

I think the first line of defense has got to be a well-informed investing public, and a leery investing public. Not a bunch of sheep that move in huge numbers on false and misleading rumors, for instance. You cannot abandon responsibility or try to go to a riskless market; those are not practical options.

And I do not think that that is what is going on. I think that by and large the investing public is very well advised, and they are looking before they leap. But some do follow as a herd on some of these false and misleading rumors, for instance.

Mr. WIRTH. Well, Mr. Chairman, we appreciate your being here and all of your colleagues. And again, we welcome Mr. Grundfest and Mr. Fleishman, and assure you that there will be further hearings. I know you are looking forward to those.

I would also like to again commend you, Mr. Chairman, on 5 years and 13 hearings. And there is some solace in that, to remind you that you have been here for 13 hearings and I have been here for 13 hearings.

Thank you very much.

[Whereupon, at 12:49 p.m., the subcommittee hearing was adjourned.]

○